Insolvency close-out netting: A comparative study of English, French and US laws in a global perspective

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Insolvency Close-out Netting

A Comparative Study of English, French and US Laws in a Global Perspective

B. MUSCAT

Insolvency Close-out Netting:

A comparative study of English, French and US laws in a global perspective

In loving memory of my parents.

Insolvency Close-out Netting

A comparative study of English, French and US laws in a global perspective

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List of Acronyms

ACPR	Autorité de contrôle prudential et de résolution (France)
BAPCPA	Bankruptcy Abuse Prevention and Consumer Protection Act (US)
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
Brexit	Exit of the United Kingdom from the EU
BRRD	Bank Recovery and Resolution Directive (EU)
CPSS	Committee on Payment and Securities Systems (BIS)
DIP	Debtor-in-possession (US)
EACB	European Association of Cooperative Banks
EBA	European Banking Authority (EU)
EBF	European Banking Federation
EMA	European Master Agreement
ESBG	European Savings Bank Group
EU	European Union
FCAR	Financial Collateral Arrangements (No. 2) Regulations (UK)
FCD	Financial Collateral Directive (EU)
FDIA	Federal Deposit Insurance Act (US)
FDIC	Federal Deposit Insurance Corporation (US)
FDICIA	Federal Deposit Insurance Corporation Improvement Act (US)
FSB	Financial Stability Board
GMRA	Global Master Repurchase Agreement
IATA	International Air Transport Association
IBA	International Bar Association
ICMA	International Capital Markets Association
ISDA	International Securities and Derivatives Association, Inc.
IMF	International Monetary Fund
Intro	Introduction
OLA	Orderly Liquidation Authority (US)
OTC	Over-the-Counter
QFC	Qualified Financial Contract (US)
SFD	Settlement Finality Directive (EU)
SIFI	Systemically Important Financial Institution
Sifma	Securities Industry and Financial Markets Association
SRB	Single Resolution Board (EU)
SRM	Single Resolution Mechanism (EU)
SSM	Single Supervisory Mechanism (EU)
INSOL	Association of International Insolvency Practitioners
UK	United Kingdom
UNCITRAL	United Nations Commission on International Trade Law
UNIDROIT	International Institute for the Unification of Private Law
US	United States
USC	United States Code

Introduction

Introduction to the Notion of Insolvency Close-out Netting

In its simplest form, netting is the process by which claims owed reciprocally by two debtors in their bilateral relations are compensated or reconciled with each other so that only one net amount is payable, unless the claims totally extinguish each other. Thus, if two parties enter into various business deals with each other with the result that each of them has various claims against the other under the individual transactions, they may agree on a calculation method by which the various claims are converted into a single amount to be paid by one party to the other. The concept of netting in this basic form resembles the classic concept of *compensatio* or set-off, *i.e.* the cancellation of mutual claims or cross demands, regulated since ancient Roman times.[1]

Derived from the concept of netting, close-out netting is typically a contractual mechanism created by contract which entitles one of the parties, upon the occurrence of a pre-defined event related to the other party's obligation, to liquidate outstanding obligations at a relevant date and reduce the multiple amounts due between the parties to a net amount. The close-out netting process of a standard netting contract comes into operation either by a notification sent by the non-defaulting party upon the occurrence of the termination event or it is triggered automatically upon the occurrence of that event. The mechanism extends to existing or future financial obligations between the parties that are included in the netting contract. Upon close-out, all outstanding obligations are liquidated, and the value of each is determined in terms of a valuation mechanism normally defined in the netting contract itself. The aggregate value of all obligations is calculated to achieve one single payment obligation.

In order to give a numerical illustration of how close-out netting works, it can be assumed that Party A and Party B have entered into numerous transactions between them. When Party A starts to default on its obligations, all outstanding transactions are liquidated, their values calculated and combined into a single net payable or receivable amount. For the purposes of this illustration, it is assumed that the global amount owed by A to B is €1 million whilst the global amount owed by B to A is €800,000. If the contractual arrangements between the two parties does not allow close-out netting,

1 Further analysis of the concepts of *compensatio* and set-off, including their origins in Roman law, and their relationship with netting is made in Chapter 1.2.

then B would have to participate in creditors' joint action to get paid the global amount due by A, whilst B would be forced to pay the whole amount due to A (unless B is otherwise exempt under the contract from making such payment). If close-out netting is permissible, the two amounts are set off against each other and only €200,000 remains owing by A to B.

For the purpose of this research, the term 'insolvency close-out netting' refers to the situation where the close-out netting mechanism is triggered by the insolvency of one of the parties.[2] The event of insolvency is arguably the most important trigger for the mechanism of close-out netting because it is upon insolvency that the more serious risks, in particular systemic risks, are deemed to arise. Systemic risk arises out of interconnectedness between counterparties where market participants are exposed to each other's failure in such a way that the inability of one financial market participant to meet its obligations when due will cause other market participants to fail to meet their own obligations.[3]

The widespread use of netting initially gained momentum in the field of payments and securities settlement, where it was realised that netting schemes could result in significant saving of routine liquidity.[4] In a typical inter-bank payment netting system, the various payment orders entered into the system by the participating clearing banks in favour of other participants are transmitted to a netting agent who calculates the net overall position of each participant at a stipulated cut-off time. Participants with net debit positions effect settlements in favour of participants with net credit positions. Once all settlements have been effected, the individual payment orders of the day included in the netting process are deemed fulfilled. Resort to the netting process is also made in the derivatives[5] and repurchase[6] markets where netting arrangements are essentially bilateral, typically based on master agreements. These are standard market agreements sponsored by market organisations formulated to ensure that in the event of a default by one party the various bilateral transactions between that party and the defaulting party are liquidated in one net close-out amount or exposure. Prime examples of such agreements include the ISDA Master Agreements sponsored by the International Securities and Deriva-

2 The reference to insolvency in this research includes also the analogous term bankruptcy used in some jurisdictions.

3 BIS 1989 Angell Report 10. For a conceptual discussion on systemic risk, see SCHWARCZ (2008); SCOTT (2012); LASTRA (2015) 180.

4 GIOVANOLI (1997) 525. It may be considered generally that modern netting has been used in the financial markets since the 1970s when the first swaps started to be documented. See PEERY (2012) 270.

5 The term 'derivatives' covers a range of products which derive their value from other products or indices. The term does not have a precise legal definition but is taken to cover a range of financial products taking the form of options, forwards and swaps.

6 The term 'repurchase' or 'repo' refers to a contract for the sale and repurchase of securities. For instance, a seller sells bonds to a buyer for an agreed cash price and commits at the same time to buy back equivalent bonds of the same issuer at an agreed future date for the same cash price plus a rate of return called the repo rate.

tives Association, Inc. (ISDA)[7] and the Global Master Repurchase Agreements (GMRA) sponsored by the International Capital Markets Association (ICMA)[8] and the Securities Industry and Financial Markets Association (Sifma).[9] These agreements govern specific transactions or categories of transactions (such as derivatives, foreign exchange transactions, securities lending and repurchase agreements) from time to time entered into by two parties under it – each transaction being recorded in a confirmation exchanged or countersigned between the parties – so that each separate transaction is deemed to form part of a single agreement contained in and subject to the terms of the master agreement.[10]

The modern reference to netting as a financial market tool is probably rooted in a report dating back to 1990, namely the Bank for International Settlements (BIS)[11] *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten countries*, known as the Lamfalussy Report, which concluded that although 'netting can […] reduce the size of credit and liquidity exposures incurred by market participants and thereby contribute to the containment of systemic risk', such 'reductions in exposures, however, depend upon the legal soundness of netting arrangements in producing net binding exposures that will withstand legal challenge.'[12] Since then, a number of jurisdictions worldwide sought to grant recognition to close-out netting and have enacted laws which permit the enforceability of a financial netting contract following the commencement of insolvency proceedings.[13]

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7 ISDA is a private association of dealers in the securities and derivatives markets. Its main achievement has been in developing the ISDA Master Agreements and in promoting the enforceability of their netting and collateral provisions. See ISDA's website at < http://www2.isda.org/about-isda/>.

8 ICMA is a private association operating in the capital markets representing the interests of associated investment banks, asset managers, exchanges, central banks, law firms and advisers. It promotes market conventions and standards in relation to instruments used in the capital markets, such as repurchase agreements. See ICMA's website at <http://www.icmagroup.org/>.

9 Sifma is a US industry trade group representing securities firms, credit institutions and asset management companies. See Sifma's website at <http://www.sifma.org/>.

10 Other important international standard market agreements include the European Master Agreement for Financial Transactions, a multi-product master agreement sponsored by the European Banking Federation; the International Foreign Exchange Master Agreement sponsored by the New York Foreign Exchange Committee; and the Global Master Securities Lending Agreement sponsored by the International Securities Lending Association.

11 The BIS is an international organisation of central banks which fosters international monetary and financial cooperation and serves as a bank for central banks. See the BIS website at < https://www.bis.org/>.

12 BIS 1990 Lamfalussy Report, paras 2.2 and 2.3. See also VEREECKEN & NIJENHUIS (2003), Preface p IX.

13 According to information published by ISDA, there are over seventy jurisdictions which provide for the enforceability of netting contracts in the light of the application of insolvency laws. The list of these jurisdictions is available on the ISDA website at <http://www2.isda.org/functional-areas/legal-and-documentation/opinions/>.

The phrase 'in accordance with its terms' is the term commonly used to denote the standard of enforceability recommended by industry associations for close-out netting provisions. This implies that close-out netting rights are exercised on the basis of a private contract and, generally speaking, are subject to party autonomy.[14] This standard is reflected in arguably the most important legal act of the European Union (EU) harmonising rules on close-out netting, namely Article 7(1) of Directive 2002/47/EC on financial collateral arrangements[15] (the Financial Collateral Directive or FCD) and is also reflected in soft law-type of declarations such as Principle 6(1) of the Principles on the Operation of Close-out Netting Provisions published by the International Institute for the Unification of Private Law (the UNIDROIT Principles).[16] This standard, in its absolute sense, is stated to mean in the explanatory text to Principle 6 of the UNIDROIT Principles that the operation of close-out netting provisions should be governed by the terms agreed by the parties, both before and after the commencement of insolvency proceedings and, as a general rule, the implementing States should not impair the operation of close-out netting provisions by imposing restrictions under national laws and regulations.[17]

The parties typically choose the law applicable to the close-out netting contract, the so-called *lex contractus*, and, outside of an insolvency situation, this law will govern the issues of validity and enforceability of the close-out netting provision. If one of the parties to a netting agreement becomes insolvent, the rules which determine the applicable insolvency law are those of the law of the forum, i.e. the jurisdiction which opens insolvency proceedings over the relevant party, the so-called *lex fori concursus* or *lex concursus*. It is a rule of private international law that the mandatory rules of the *lex concursus* might supersede those of the *lex contractus* to the extent that there is a conflict with the effect of the *lex concursus*, unless there is a specific carve-out under the *lex concursus*.[18]

It is fair to say that guaranteeing the enforceability of insolvency close-out netting has changed the traditional goalposts set by insolvency regimes in a number of jurisdictions. A traditional policy approach of insolvency law generally consists in securing as many assets as possible for the insolvent estate and for this purpose some jurisdictions impose a stay on creditors from enforcing their individual rights. To the extent that close-out netting

14 BöGER (2013) 240.

15 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, [2002] OJ L 168/43, as amended by Directive 2009/44/EC, [2009] OJ L 146/37, and Directive 2014/59/EU, [2014] OJ L 173/190.

16 UNIDROIT 2013 Close-out Netting Principles. UNIDROIT is an independent intergovernmental organisation set up under a multilateral agreement to study needs and methods for modernising, harmonising and co-ordinating private (commercial) law and to formulate uniform law instruments. See its website at < http://www.unidroit.org/>.

17 *Ibid*. 48.

18 See UNIDROIT 2011 Close-out Netting Report 33. See also DALHUISEN (2019) Volume 3, p 410.

is enforceable, claims and assets are not drawn into the insolvent estate but remain immediately available as liquid assets for the netting creditor. The race for the enforcement of claims where the prize goes to the swiftest and individual assets of the insolvent debtor are dismembered in the process of individual execution by the creditors has been considered detrimental to the efficient organisation of the insolvent debtor's affairs by several authors since it dismembers parts of the estate and may significantly frustrate the possibility to rehabilitate the debtor. Indeed, following the financial crisis of 2008-2009, the extent of the enforceability of close-out netting provisions in the case of a failure of an important financial market player has been questioned.[19] This is evident in recent statements and developments regarding the effectiveness of resolution measures in respect of credit institutions and certain investment firms where it is recommended that resolution authorities should be empowered to impose a temporary stay on the termination rights exercisable under close-out netting provisions in order to decide whether to transfer in full or not at all the obligations falling under a netting agreement.[20] Such measures have been adopted, for instance, in the EU in terms of national measures implementing Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms[21] (the Bank Recovery and Resolution Directive or BRRD), which is to be considered together with Regulation EU/806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund[22] (the Single Resolution Mechanism Regulation or SRM Regulation). The main reason for

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19 See, in particular, the views of US academics in this respect, e.g. LUBBEN (2010) 319; AYOTTE & SKEEL (2009) 494; SKEEL & JACKSON (2012) 153; ROE (2011) 541; TUCKMAN (2010) 3.

20 See FSB 2011 Key Attributes, Sections 4 & 5.

21 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/30/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, [2014] OJ L 173/190, Articles 71, 76 & 77. The BRRD has been amended by the so-called BRRD II, *i.e.* Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC, [2019] OJ L 150/296.

22 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] OJ L225/1. The SRM Regulation has been amended by the so-called SRM II Regulation, *i.e.* Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms, [2019] OJ L 150/226. SRM II will apply from 28 December 2020.

this development is that close-out netting should not frustrate the orderly implementation of resolution measures to the detriment of the financial stability of the markets, provided adequate safeguards for the close-out netting provision are in place.[23]

A Research Methodology

A.1 Research Question

The close-out netting process, when it takes effect 'in accordance with its terms' in insolvency, has provided financial market participants with a substantial measure of self-help in enforcing their claims against an insolvent counterparty. Whilst the recognition granted to close-out netting provisions is now globally widespread,[24] the extent to which recognition is given by national legislators to the standard set by industry, i.e. recognition 'in accordance with its terms', may vary from one jurisdiction to another. The term 'recognition' is an important term of the research question and will be frequently used throughout this research, at times in conjunction with the term 'enforceability' or 'enforcement'. It is considered in modern literature in the analogous context of foreign judgments and arbitral awards that the distinction between recognition and enforcement does not have significant practical value since international enforcement conventions do not establish separate procedures for recognition and enforcement, *i.e.* there is no double *exquatur*.[25] Traditionally, however, a distinction is typically drawn between the two terms. Thus, recognition refers to the situation where the law or the court recognises the legal force and effect of a legal concept, contractual provision or decision, whilst enforcement or enforceability refers to the faculty to carry out and execute, apply or implement such concept, provision or decision, possibly (and depending on the case) by imposing legal sanctions.[26] Given that the recognition of a concept is the first step of the process which may later lead to its enforceability, predominant use in this research will be made to the aspect of recognition of a close-out netting provision. This is consistent with the terminology used under the EU's Financial Collateral Directive which in the heading of Article 7 refers to the 'Recognition of close-out netting provisions' whilst the text of Article 7(1) refers to a close-out netting provision taking effect in accordance with its terms, this (i.e. 'takes effect') being a reference to one aspect stemming

23 For a general understanding of the notion of 'financial stability' in the context of this research, see MOFFATT (2015) 493.

24 ISDA announces on its website that it has legal opinions on the enforceability of close-out netting in seventy-five jurisdictions. See <https://www.isda.org/opinions-overview/> accessed 26 December 2019.

25 BUNGENBERG & REINISCH (2019) 480.

26 KRONKE *et al.* (2010) 150.

from recognition. However, elements of enforceability will also be analysed in this research as it may at times be difficult to establish when recognition ends and enforceability begins. For instance, in the case of mandatory insolvency laws which may affect the implementation of close-out netting provisions, is this a case of partial recognition or partial enforcement? Thus, whilst the main process referred to in this research is to recognition of close-out netting, it is not excluded that reference will also be made to enforceability where use of this term is deemed more appropriate.

This research is based on the premise that close-out netting developed as a market tool under the *lex mercatoria* based primarily on the (private and cross-border) standard rules or master agreements of market associations and, secondarily on external factors such as declarations and recommendations of international regulatory bodies which are deemed to have produced a transnational effect on the development of close-out netting. Based on this premise, this research will examine the influence of the legal systems of England (*i.e.* England and Wales), France and the United States of America (US) on the recognition of close-out netting provisions in insolvency. In more detail, the research will consider (i) whether the development of the concept of close-out netting in these jurisdictions has been influenced by the respective jurisdiction's set-off rules or whether close-out netting has developed as an autonomous concept, (ii) whether the recognition given to close-out netting 'in accordance with its terms' has been affected by the norms and rules of the jurisdictions' national insolvency laws and state insolvency goals (and, if so, in what manner), and (iii) whether, following the global financial crisis of 2008 – 2009, a convergence can be noted in (restrictions imposed on) the recognition of close-out netting provisions under these jurisdictions' national resolution regimes (and, if so, in what manner).

The choice of these jurisdictions has been motivated by the fact that they pertain to different global legal systems which is expected to bring out differences in the development of insolvency close-out netting as a consequence of their diverse historical and legal heritage. Thus, English law is fundamentally based on the common law tradition. French law, on the other hand, operates a civil law system based on Roman law, initially codified through the Napoleonic Code.[27] US law, though following the common law tradition brought to the North American colonies from England, has traces of the civil law tradition in its state legal systems[28] and may, to some extent, be considered as an eclectic system comprising elements of the civil and common law system and also home-grown elements.

On the basis of the above considerations, the main question to be addressed in this research is therefore the following:

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27 *Code civil des Français*, Law 1804-02-07.

28 Most notable is the case of Louisiana, where state law is based on civil law on account of its history as a French and Spanish territory prior to its acquisition from France in 1803.

How does close-out netting in insolvency function under current English, French and US laws, and, more specifically, how have the legal systems of these jurisdictions influenced the recognition of insolvency close-out netting provisions?

Thus, the topic of close-out netting in insolvency under present English, French and US laws is approached from a historic-theoretical perspective. In order to address this main question, a number of ancillary questions will be tackled as indicated below:

(a) First, in what ways has the classic concept of set-off under the three selected jurisdictions influenced the recognition of close-out netting provisions? Is close-out netting considered a contractual enhancement of set-off or is it a stand-alone concept having its foundations in the *lex mercatoria*?

(b) Second, in what ways has the recognition of close-out netting provisions 'in accordance with their terms' been affected by the principles of national insolvency laws and by State insolvency goals?

(c) Third (and final), following the global financial crisis of 2008 – 2009, has there been a convergence in relation to the type of restrictions imposed on the enforceability of close-out netting provisions under the national resolution regimes? Which aspects of the *lex mercatoria* may have contributed to such development?

It will be explained in more detail how the research question and sub-questions will be tackled in the part of this Introduction dealing with the structure of the research. Beforehand, it is proposed to first provide a brief understanding of the concepts of legal systems and the *lex mercatoria* as used in this research.

A.2 Origins of the Common and Civil Law Systems

Chapters 4 to 6 of this research are dedicated to a comparative study of the regulation of insolvency close-out netting under English, French and US laws. A brief description of the salient points of the history and of the characteristics of the common and civil law traditions may assist in understanding the historical foundations for the development of the insolvency close-out netting laws of the three selected jurisdictions and their preparedness to adapt to the *lex mercatoria*.[29]

The common law tradition emerged in England during the Middle Ages and was later exported to British colonies across continents, including the US. In the Middle Ages justice was delivered by a system of *writs*, or royal orders, emanating from the king, each providing a specific remedy for a specific wrong. Since this system did not adequately achieve justice,

29 A detailed analysis of the common and civil law systems is outside the scope of this research. See for a detailed analysis, TETLEY (2000); APPLE & DEYLING (1995).

a further appeal could be made to courts of *equity* presided by judges appointed by the king. The king's judges were obliged to adopt an earlier judge's interpretation of the law and apply the same principles if two cases were based on similar facts. The term common law was gradually used to describe the law held in common in these courts.[30] Common law has developed a number of distinguishing characteristics. It is generally uncodified, meaning that there is no comprehensive compilation of legal rules and statutes, and is largely based on precedent, meaning that if a similar dispute has been resolved in the past, the court is usually bound to follow the same reasoning (known in Latin as *stare decisis*). If, however, the court finds that the current dispute is fundamentally distinct from all previous cases, judges have the authority and duty to make law by creating precedent. As a result, judges have a notable role in developing the law. The common law process is thus based on inductive reasoning, deriving general principles or rules of law from precedent and extracting an applicable rule to be applied to a particular case. Statutes in a common law jurisdiction tend to be comprehensive, provide detailed definitions, each specific rule sets out lengthy enumerations of specific applications or exceptions and are interpreted to meet the subjects' reasonable understanding and expectations. Common law moves from case to case, is factual and results-oriented, and leaves room for other sources of law in trade, commerce and finance, especially industry practices or customs supported by party autonomy and therefore by the order that participants themselves create. The former distinction between law and equity was also important for the development of commercial and financial law in common law systems. Thus, Dalhuisen notes that certain features of the ordinary law of contracts, such as the concept of consideration does not affect certain commercial agreements such as the agreement to transfer negotiable instruments, implemented through delivery or endorsement. This underscores the point that integration between ordinary (common) law and commercial law (formerly based on other sources such as equity and custom) may not fully exist in common law countries.[31]

The civil law tradition developed in continental Europe at the same time and was applied in the colonies of European imperial powers such as Spain and Portugal. The term civil law derives from the Latin *jus civile*, the law applicable to all Roman citizens. Its origins derive from the Justinian Code of the sixth century, a codification which was strongly influenced by the opinions of jurists sought by lay Roman judges. This Code was re-discovered and taught in universities in the eleventh century in Italy.

30 In the seventeenth century the English Parliament claimed the right to define the common law and declared other laws subsidiary to it. The first systematic treatise on English common law was drafted by William Blackstone in his *Commentaries on the Laws of England* (1723-1780). Parliament later acquired legislative powers to create statutory law, but this was considered to apply as complementary to the older common law rules.

31 DALHUISEN (2019) Volume 1, p 20.

Medieval scholars of canon law were also influenced by Roman law as they compiled existing religious legal sources for their own comprehensive system of law for the Church. By the late Middle Ages, these two laws, civil and canon, constituted the basis of a shared body of legal thought common to most of continental Europe giving rise to the medieval *Corpus juris civilis*. The role of local custom (known as law merchant) as a source of law became increasingly important and during the early modern period this led to academic attempts to codify legal civil law provisions and local customary laws.[32] Such codes, shaped by the Roman law tradition, are the models of today's civil law systems.[33] The traditional characteristic of the civil law system is the codification of legislation so that the commercial and financial laws of the country are part of this codification process which is complete and capable of finding solutions for all eventualities. The first step in interpreting an ambiguous law is to discover the intention of the legislator by examining the legislation as a whole, including the *travaux préparatoires*. Dalhuisen remarks that the approach is rule-oriented and change is dependent on legislation by the state, with the legislator making the necessary choices and ultimately also determining the relevant values. Notwithstanding this, civil law codes and statutes are concise and provide no or few definitions. The reasoning process is deductive – conclusions about specific situations are derived from general principles. Case law is advisory, but not binding, when there is a long series of cases using consistent reasoning (known as *jurisprudence constant*). The law is not typically analysed for its continuing fairness or morality, efficiency or responsiveness to social or economic needs. The system is closed and extraneous sources of law are irrelevant with the result that custom and party autonomy can only operate to the extent the written law specifically permits. According to Dalhuisen, this strict approach to party autonomy goes far beyond the ordinary constraints derived from public order and public policy considerations which parties must respect and accept as overriding. It concerns the validity of the agreement itself, which depends on express legislative recognition.[34]

These traditional characteristics of the civil and common law systems have led to distinct approaches in the development of their laws. First, although common law judges are bound by precedent, they may re-inter-

32 The most distinguished of these scholars is the Dutch jurist Hugo Grotius whose 1631 work, *Introduction to Dutch Jurisprudence*, synthesized Roman law and Dutch customary law into one compendium. See APPLE & DEYLING (1995) 12 *et seq.*

33 The leaders of the codification process in modern continental Europe were France and Germany. In France the *Code Napoleon* of 1804 was disseminated in countries conquered by Napoleon's armies. Its structure is influenced by Justinian's *Corpus Juris Civilis*. Its language is simple and clear, since it was designed to be understood by every citizen. The Napoleonic Code has been amended and supplemented by later legislation but has not been completely revamped. The German *Bürgerliches Gesetzbuch* or BGB of 1900 is largely the product of codification processes in three Germanic states: Bavaria, Prussia and Austria. *Ibid.* 14, 20.

34 DALHUISEN (2019) Volume 1, p 9.

pret and revise the law without legislative intervention to adapt to new trends in political, legal and social philosophy. This causes common law to evolve through a series of gradual steps, so that over a decade or more the law can change significantly and new concepts may enter the legal system in response to the changing needs of society. Second, common law provides the precise law that applies to a particular set of facts by locating precedential decisions on the topic. This provides an element of certainty of application of the law and renders commercial contracts more economically efficient. Third, traditionally there is a tendency for common law jurisdictions to have pro-creditor laws, whilst civil law jurisdictions whose laws originate from the Napoleonic Code such as France are generally pro-debtor in their approach to insolvency. The relevance of this distinction is that whilst the insolvency regimes of common law jurisdictions tend to recognise the right of creditors to protect themselves against default through *ex ante* contractual agreements that permit the solvent counterparty to close out contracts and net obligations, civil law jurisdictions traditionally seek to maximise the value of the insolvent estate with the result that preferential privately-negotiated *ex ante* contractual arrangements may be rendered ineffective during insolvency judicial proceedings.[35] The selection of jurisdictions has therefore been made with the intention of bringing out contrasts in the application of their insolvency close-out netting laws under the assumption that these are influenced by the diverse traditions of their legal systems.

A.3 Definition of *Lex Mercatoria*

One of the aspects examined in this research is the influence of the *lex mercatoria* on the development of the close-out netting laws of the three selected jurisdictions. In this part an understanding of the term *lex mercatoria* for the purposes of this research is provided. First, in order to appreciate the diversity of this concept, the views of some authors on what constitutes the *lex mercatoria* is synthesised below. This is followed by a description of those elements of the *lex mercatoria* which are considered relevant for the purposes of determining its influence on the development of the three selected close-out netting regimes.

There is broad consensus in doctrine that the *lex mercatoria* is related to commercial and financial law and is based on international dealings or professional cross-border activities. It transcends the national legal system and emanates from a legal order of its own. Apart from this general understanding, there are somewhat diverse views on what constitute the sources of the *lex mercatoria*. Dalhuisen considers that the *lex mercatoria* is not national or territorial and results from the spontaneous bottom-up law

35 According to Bergman *et al.*, these approaches 'have at their roots two fundamentally irreconcilable concepts of fairness'. BERGMAN *et al.* (2004) 7.

formation in which custom and practices, treaty law, general principle and party autonomy play the defining roles. It is thus, according to this author, not a single systematically coherent body of law but is the result of a hierarchy of these various sources of law which will seek to rearrange the risks and financial consequences normally foreseen under national law. Goode also confines the *lex mercatoria* to international trade practice related to the spontaneous generation of instruments of harmonisation and which results from a variety of forms of soft law, including model laws, legislative guides, contractually incorporated uniform rules, trade terms promulgated by international business organisations and international restatements by scholars. He considers that contracts cannot by themselves constitute a source of law since they have effect only by virtue of recognition by a national legal system and are restricted by rules of public policy or mandatory rules. He considers that the *lex mercatoria* should not be dependent on external legal recognition and its effectiveness lies in the fact that the industry perceives its observance as necessary to the fair and efficient conduct of business.[36] Druzin's views combine elements of both approaches taken by Dalhuisen and Goode. Thus, similar to Dalhuisen's view, Druzin considers that the *lex mercatoria* unfolds both on the macro level of state actors where its sources are complex international agreements, as well as on the micro level where the driving force are private contracts resorting to customary law and international arbitration. Similar to the views of the other two authors, he describes the *lex mercatoria* as a commercial transnational legal order that possesses built-in structural features that allow it to self-standardize and sustain itself without a central authority.[37]

Although there is no general agreement of what constitutes a source of law for the purposes of defining the *lex mercatoria*, there is a general understanding that the *lex mercatoria* is constituted by a hierarchy of various sources of what have been termed by Goode as 'soft law'. This implies that

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36 GOODE (2005) 547. Notwithstanding this assertion, Goode cites the case of the 2001 Cape Town Convention on International Interests in Mobile Equipment as the most ambitious problem-solving convention regulated by its own Supervisory Authority and which aims to address the problem of taking and retaining rights *in rem* in assets such as aircraft objects, railway rolling stock and space assets that are constantly moving from one jurisdiction to another or, in the case of satellites, are not on earth at all. *Ibid.* 557.

37 DRUZIN (2014) 1052. By way of summary, Druzin considers that three elements are key to the transnational legal order created by the *lex mercatoria*, namely reciprocity, the practical requirements of the market and the existence of network effects. First, reciprocal gains from the recognition of the rules of property and contract stimulate voluntary compliance. Second, the requirements of the market tend to create a degree of general uniformity in these practices because uniformity itself provides a benefit. Commercial legal structures emerge in the form of instruments of the market, formulated spontaneously in a decentralised fashion out of sheer practical necessity. Because these legal structures emerge in line with the needs of the market, and because these needs tend to be the same everywhere, a degree of general uniformity results. Third, high degrees of uniformity arise as network effects push the market for legal rules toward ever-higher levels of standardisation. *Ibid.* 1056, 1075, 1079.

although these sources are not directly binding in national regimes, they command a sufficient strong and consistent following in financial and commercial societies as to form an identifiable and morally cogent normative regime.[38] Applying this understanding to the development of close-out netting regimes, relevant sources for a *lex mercatoria* are those that may have influenced legislators in adapting national laws to grant recognition to close-out netting provisions developed on the basis of party autonomy. The sources identified in this respect are custom, party autonomy, standard-term international agreements, model laws and legislative guides. Chapter 3 will enumerate and explain those sources which are deemed to have instigated the promulgation of national close-out netting regimes, amongst which are the reports of public international bodies such as the Lamfalussy Report of the Committee on Interbank Netting Schemes of the BIS (1990),[39] the Giovannini Report (2001),[40] the World Bank Principles for Effective Creditor Rights and Insolvency Systems (2001),[41] the United Nations Commission on International Trade Law (UNCITRAL)[42] and the Legislative Guide on Insolvency Law (2004).[43] Chapter 3 will also consider sources related to private association efforts to promote the global statutory recognition of close-out netting provisions, foremost among these is ISDA

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38 A similar view is expressed by Mevorach that what may have initially started as a 'soft law' may become a source of law through the influence of peer pressure. Mevorach opines that universalism can crystallise into binding law in the form of 'customary international law' where there is belief that a practice conforms to international law. See MEVORACH (2018) 259.

39 BIS 1990 Lamfalussy Report.

40 EUROPEAN COMMISSION 2001 Giovannini Group First Report, Barrier 14.

41 WORLD BANK Principles (2001), Principle 14. The World Bank is a United Nations international financial institution created out of the Bretton Woods Agreement in 1944 to provide finance to European and Asian countries needing finance to fund reconstruction efforts after the Second World War. Today it is dedicated to provide finance, advice and research to developing nations to aid their economic development. See the World Bank's website at < http://www.worldbank.org/>.

42 UNCITRAL is a legal body of the United Nations in the field of international trade law specialising in commercial law reform. See its website at <http://www.uncitral.org/>.

43 UNCITRAL Legislative Guide (2004), Recommendations 7(g) and 101-107. The UNCITRAL Legislative Guide is divided in four parts. Part one discusses the key objectives of an insolvency law and structural issues such as the institutional framework required to support an effective insolvency regime. Part two deals with core features of an effective insolvency law. Part three (adopted in 2010) addresses the treatment of enterprise groups in insolvency, both nationally and internationally. Part four (adopted in 2013) focuses on the obligations that might be imposed upon those responsible for making decisions with respect to the management of a failing enterprise. Work proceeded through a joint colloquium with the Association of International Insolvency Practitioners (INSOL), a worldwide federation of national associations for accountants and lawyers who specialise in insolvency, and the International Bar Association (IBA), a global organisation of international legal practitioners, bar associations and law societies. The Legislative Guide was adopted by the United Nations General Assembly on 2 December 2004.

with its master agreements and its ISDA Model Netting Law.[44] Chapter 3 will further assess the impact of EU law in the area of close-out netting which is foremost a primary (binding) source of law for EU Member States but which may have exerted influence beyond the EU for other countries who wish to remain competitive in the market and may thus be considered as a special *lex mercatoria*.

It is interesting to note the remarks made by Dalhuisen and Goode on the congruence or acceptance of the *lex mercatoria* in common and civil law jurisdictions. Dalhuisen remarks that the *lex mercatoria* in international dealings partakes of the characteristics of common law and this is apparent in the greater reliance on practices, custom and party autonomy, in its operating from case to case, its sensitivity to the facts and in supporting new business structures.[45] Goode notes that the *laissez-faire* approach of the *lex mercatoria* is much less acceptable to civil law jurisdictions where a number of rules particularly in property law are incompatible with modern methods of dealing and finance.[46] Both authors agree that modern states wanting to benefit from globalisation are likely to adjust their regulatory regimes to transnational standards in order to create a more level playing field for market players. It may therefore be the case that also modern civil law jurisdictions are amenable to adapt their laws as a response to the needs of international commerce and finance to ensure that their legal systems remain competitive.

A.4 Methodology

This research considers a number of laws regulating close-out netting. From an EU perspective, it analyses the relevant close-out netting provisions of, *inter alia,* Directive 98/26/EC on settlement finality in payment and securities settlement systems (the Settlement Finality Directive),[47] the Financial Collateral Directive, the Bank Recovery and Resolution Directive in conjunction with the Single Resolution Mechanism Regulation and Directive 2001/24/EC on the reorganisation and winding up of credit institutions ('the Banks Winding-Up Directive').[48] The research also includes a comparative analysis of the insolvency close-out netting laws of (i) England

44 There are various versions of the ISDA Model Netting Law, the most recent being the 2018 ISDA Model Netting Act and Guide (October 15, 2018).

45 DALHUISEN (2019) Volume 1, 25.

46 GOODE (2005) 541.

47 Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, [1998] OJ L 166/45, as amended by Directive 2009/44/EC, [2009] OJ L146/37, Regulation (EU) No 648/2012, [2012] OJ L 201/1 and Regulation (EU) No 909/2014, [2014] OJ L 257/1.

48 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, [2001] OJ L 125/15, as amended by Directive 2014/59/EU, [2014] OJ L 173/190.

(mainly the Financial Collateral Arrangements (No. 2) Regulations 2003,[49] the Insolvency (England and Wales) Rules 2016[50] and the Banking Act 2009[51]); (ii) France (the Civil Code, the Commercial Code and the Monetary and Financial Code); and (iii) the US (the Bankruptcy Code,[52] the Federal Deposit Insurance Act of 1950 (FDIA),[53] the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)[54] and Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)).[55] To the extent they are illustrative or contribute to the development of law, important judgments delivered in these jurisdictions are also cited.

Reference is also made to international best practice guidelines issued by international organisations on the drafting of national netting legislation, such as the UNIDROIT Principles on the Application of Close-out Netting, the UNCITRAL Legislative Guide on Insolvency Law and the ISDA Model Netting Act which provide recommendations to legislators on how to design legislation on insolvency close-out netting. Reference will also be made to reports of the BIS, including its sub-structures, the Financial Stability Board (FSB),[56] the International Monetary Fund (IMF)[57] and the World Bank insofar as these provide important declarations on the role of insolvency close-out netting in the financial markets.

The close-out netting instruments typically concluded by financial market participants are the standard master agreements. This research analyses the close-out netting provisions of two important master agreements, namely the 2002 ISDA Master Agreement used for derivatives transactions and the 2011 Global Master Repurchase Agreement. The implications of the close-out netting provisions of these master agreements provide insight into the different ways in which the close-out netting technique operates in the derivatives and repurchase markets.

These prime sources are supplemented by the writings of European and US academics in the fields of close-out netting, set-off and insolvency. Material used has been sourced through academic research and digital research, and all sources used are publicly accessible through on-line sources or

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49 S.I. 2003/3226.

50 S.I. 2016/1024.

51 2009 c. 1.

52 Title 11 of the United States Code, 11 U.S.C.

53 Pub.L. 81-797, 64 Stat. 873.

54 Pub.L. 102-242, 105 Stat. 2236.

55 Dodd-Frank Wall Street Reform and Consumer Protection Act (June 21, 2010) (Pub.L. 111-203, H.R. 4173).

56 The FSB is the successor to the Financial Stability Forum set up by the Group of Twenty to promote the reform of international financial regulation. See its website at < http://www.financialstabilityboard.org/>.

57 The IMF is an international organisation having 188 member countries which was set up in 1945 to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable growth, and reduce poverty in the world. See the IMF's website at <http://www.imf.org/external/index.htm>.

libraries or other public sources.[58] This research therefore follows the classic legal methodology and is limited to the use of legal texts, case law and standard market agreements. It does not purport to cover issues related to private international law, except to the extent this is inevitably linked with the assessment of the research question, nor does it attempt to study the role of close-out netting in the regulated markets of central counterparties and central securities depositories. This research focuses on the operation of close-out netting provisions in bilateral arrangements mainly in the derivatives and repurchase markets, though reference may be made to the securities lending, payment systems and inter-bank deposit markets when required to strengthen arguments expounded in this research.

B Structure of the Research

This research is divided into three parts and eight chapters.

In Part I (Introductory Chapters: Close-out Netting, Insolvency Law and Global Perspectives), Chapter 1 discusses the constitutive elements of the concept of close-out netting, its historical evolution from set-off and its use by the market in two cross-border master agreements. This chapter considers from a theoretical point of view the relationship between close-out netting and set-off and provides preliminary views on the first sub-question, namely whether close-out netting may, in theory, be considered as a contractual enhancement of the classic concept of set-off. Chapter 2 analyses the interaction between close-out netting provisions and insolvency law, focusing on the main derogations granted to ensure protection of close-out netting provisions from insolvency law. This chapter answers the second sub-question and indicates how national insolvency laws generally tend to restrict the contractual freedom of the parties in their recognition of close-out netting provisions. It also provides a theoretical answer to the third sub-question by indicating the ways in which banking resolution regimes have reshaped the recognition granted by national regimes to close-out netting provisions. Chapter 3 considers the two sources which are deemed in this research to have established a *lex mercatoria* in relation to the development of close-out netting, namely (i) the recommendations made by international regulatory bodies and the standard market documentation or agreements of private global market associations on the one hand and (ii) EU law in the field of close-out netting on the other. These first three chapters are intended

58 Whilst every effort has been made to cite the most recent or most relevant academic writing, the author wishes to state that the latest version of the publication of Philip R Wood, *Set-off and Netting, Derivatives, Clearing Systems.* (Third Edition, Sweet & Maxwell 2018) was not available even though a number of libraries and sources have been accessed for this purpose at the time of writing. Reference in this research has therefore been made to the Second Edition of this publication.

to provide a theoretical overview of the main conceptual elements used in this research and to indicate how they interact with each other.

In Part II (National Close-out Netting Regimes), each of Chapters 4, 5 and 6 analyses the extent of the recognition granted to insolvency close-out netting provisions under the laws of England, France and the US, respectively. These chapters examine for each of these jurisdictions (i) the historical development of close-out netting law and the constitutive elements of close-out netting under current law with a view to establishing the extent of recognition granted by the legislator to close-out netting, (ii) the influence which set-off rules have exerted on the development of close-out netting, (iii) the effect of national insolvency law as well as the insolvency goals pursued by the State on the type of recognition given by the legislator to close-out netting and (iv) the identification of new restrictions and safeguards to close-out netting heralded by national resolution regimes following the financial crisis of 2008 – 2009 in order to safeguard financial stability. In this Part II, sub-questions 1 to 3 will be analysed from the point of view of the national law of the three selected jurisdictions and preliminary conclusions will be drawn for each of these sub-questions in preparation for the comparative analysis carried out in Chapter 7.

In Part III (Comparative Analysis and the Influence of the Legal Systems), Chapter 7 undertakes a comparative analysis of all the aspects considered in Chapters 4 to 6 in order to establish approaches taken by legislators in formulating their close-out netting regimes. This comparative analysis also draws distinctions between the three selected jurisdictions in relation to the subject-matter of the three sub-questions, namely the extent to which close-out netting is influenced in its development by set-off rules, the effect which national insolvency principles and state insolvency goals may have had on the recognition of close-out netting provisions, and the level of harmonisation in the type of restrictions and safeguards imposed on the recognition of close-out netting by national resolution regimes. This analysis is then used in Chapter 8 to draw conclusions on the influence of the legal system of the three selected jurisdictions on the recognition granted to close-out netting provisions as developed under the standards of the *lex mercatoria* in reply to the main research question.

C Importance of the Research Question

Close-out netting is a core provision of financial netting agreements and of most collateral transactions. Industry associations, particularly in the derivatives markets, typically commission national legal opinions to ensure, to the extent possible, that reliance on the enforceability of close-out netting provisions in cross-border contracts can be safely made especially in an insolvency event. The motivation behind the choice of the research question is that firstly it aims to map the national law regimes of England, France and the US on close-out netting within these regimes globally. Secondly, to better understand the functioning of the present day's close-out netting regimes, it seeks to examine from various perspectives the adaptability and amenability of the national law regimes of these jurisdictions to accommodate this important contractual provision. Finally, it serves to demystify stereotypes which have come to be associated with certain jurisdictions in their approach and readiness to uphold debtors' or, alternatively, creditors' rights. Thus, this analysis goes beyond a mere legal assessment of the current, relevant national close-out netting provisions and how these are applied in the relevant jurisdictions. Rather, this thesis takes into consideration a wider range of influences of the legal system and of state goals which have arguably left their mark on the level of recognition granted to close-out netting provisions. The analysis will therefore take into account legal, political, moral, philosophical and other relevant factors and as a result assesses not only the level of legal recognition (including any limitations thereto) granted by these regimes to close-out netting but also the reasons and influences which led to that recognition.

Three perspectives are taken to formulate the reply to the main research question, selected to provide a holistic assessment of the nature and shape of close-out netting. The first relates to a comparison of close-out netting with the analogous general concept of set-off in commercial transactions and will thus focus on substantive private law. These two concepts are often compared in literature, albeit in a rather general way. In this research the comparison is intended to delineate the historical and current influences which served to cast the concept of set-off and considers whether these influences have been perpetuated in the development of close-out netting. The second perspective relates to the application of insolvency law and will focus on public policy issues. Insolvency law often functions as mandatory national law. It is therefore deemed that the type and extent of derogations granted from the application of insolvency law principles provide a good indication of the influence of a state's insolvency goals on the recognition given to close-out netting provisions as well as the pro-creditor or pro-debtor approach taken by the national legislator. The third perspective relates to the influence of bank resolution regimes and will focus on the implementation of public interest objectives with cross-border implications. The impetus for the enactment of national resolution regimes is due to an international movement advocating the orderly resolution of systemically important financial institutions based on the pursuit of objectives related to, inter alia, the stability of the financial system and protection against systemic risk. It is expected that the international dimension of these regimes transcends the influence of the applicable legal systems and should result in a level of convergence of certain aspects of national netting laws. Further insight into these different perspectives will be provided in this research.

Part I

Introductory Chapters: Close-out Netting, Insolvency Law and Global Perspectives

1 Introduction to Close-out Netting

1.1 Understanding Close-out Netting and the Various Netting Techniques

The term netting has acquired a specific meaning in the finance context concerned with the range of financial obligations which are taken into account to reduce the size of the obligations owed between two counterparties.[1] This chapter describes the theoretical, historical and practical aspects of close-out netting as a legal concept and is divided as follows. In the first part a brief overview is given of some technical definitions of netting derived from European Union Directives and international private declarations, of the various netting techniques and of the advantages and disadvantages of netting. This is followed by a more detailed analysis of the constitutive elements of close-out netting based on the abovementioned sources. The second part analyses practical examples of the formulation of close-out netting provisions in two important master agreements in order to give two examples of how close-out netting has been developed by the market under the *lex mercatoria*. The third part describes the historical origins of set-off dating from Roman Law and is intended to serve two main purposes: first, it gives the historical background to the discussion on whether close-out netting is to be considered a contractual enhancement of set-off under the laws of the selected jurisdictions and, second, it facilitates the discussion made later in this research of whether the philosophy on which set-off was originally based is evident or not in the development of close-out netting under the national laws of the three selected jurisdictions.

Netting Techniques

Netting as a financial market technique is a versatile risk mitigation tool developed by the financial market to serve different purposes, albeit the economic result is always the same, namely the reduction of multiple exposures into one net exposure. It may therefore take a number of forms so that the definition or boundaries of netting may vary depending on the scope to

1 According to Annetts and Murray, the term netting has been in use for not more than three decades. It is almost exclusively used in the financial and commodities sectors, and the origins of the term are more commercial than legal. Before that, the term was not widely used in statutes or referred to by judges or legal academics. However, the term now appears in European Directives and in national financial legislation. See ANNETTS & MURRAY (2012) 269.

which it refers. One important definition of netting in a European context is found in Article 2(k) of the EU Settlement Finality Directive where, in relation to payment systems,[2] netting is defined as 'the conversion into one net claim or one net obligation of claims and obligations resulting from transfer orders […] with the result that only a net claim can be demanded or a net obligation be owed.'[3] Although this definition of netting has been applied to the context of payment systems (and hence the reference to transfer orders), the reference to 'obligations' may indicate that this provision defines the elements of netting for more universal purposes and is not restricted to payment netting. According to Vereecken and Nijenhuis, however, the use of the term 'transfer orders' indicates that the reference to netting in this definition is strictly to the netting of transfer orders relating to payments of monetary amounts or transfer of interest in securities. The inclusion of the netting of other obligations is therefore not within the scope of this definition.[4]

The possibility of netting monetary and other (*i.e.* delivery) obligations is clearly worded in the definition of netting provided in paragraph 12(z) of the Introduction to the UNCITRAL Legislative Guide which defines netting as 'the setting-off of monetary or non-monetary obligations under financial contracts'. In the case of delivery obligations, these must, by implication, be capable of being reduced to monetary claims to permit the calculation of a single net amount. This is a more complex definition of netting implying the calculation of the current market value of obligations under contracts and the appropriate settlement currency in the case of a variety of foreign exchange obligations. Moreover, the UNCITRAL definition refers to netting as the setting off of obligations in the context of financial contracts. This imparts the idea that the netting of obligations is (only) achieved using the set-off process. According to UNIDROIT, a specific problem with such definitions which closely assimilate netting with set-off is whether there is any substantive netting rule at all or just set-off and, as a consequence, whether the traditional national requirements imposed on set-off would also apply to netting.[5]

In the definition of netting agreement in paragraph 12(aa), the UNCITRAL Legislative Guide refers to more than one type of netting technique as follows: '(i) the net settlement of payments due in the same currency on the same date whether by novation or otherwise; (ii) upon the insolvency or other default by a party, the termination of all outstanding

2 A payment system is generally defined under Article 2 of the Finality Settlement Directive as a formal arrangement between three or more participants with common rules and standardised arrangements for the carrying out of transfer orders.

3 Similar wording has been used in the Article 2(98) of the Bank Recovery and Resolution Directive which defines a netting arrangement as an arrangement under which a number of claims or obligations can be converted into a single net claim.

4 VEREECKEN & NIJENHUIS (2003) 43.

5 See UNIDROIT 2011 Close-out Netting Report 27.

transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or (iii) the set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements.' The UNCITRAL Legislative Guide provides a functional definition of a netting agreement which takes into account three types of netting techniques developed by the market. Thus, point (i) refers to payment or settlement netting using the novation or other technique, point (ii) refers to close-out netting and point (iii) refers to the concept of a master-master netting agreement whereby amounts set off under more than one (master) agreement are set off against each other to produce one net amount. These netting techniques are briefly described below.

Settlement netting (at times also referred to as payment netting or delivery netting) is a process for the settlement of matured payment obligations, owed reciprocally under financial contracts. The payment of the net balance extinguishes the claims on both sides. In case of commodities and investment securities, settlement netting could also cover delivery obligations which can be given a monetary value. The standard provision for settlement netting in the ISDA Master Agreement provides that amounts shall be set off across potentially all forms of derivative transactions entered into between contracting parties.[6] Usually, settlement netting is restricted to transactions denominated in the same currency. However, there is no legal restriction for counterparties to provide for settlement netting of transactions expressed in different currencies if there is a mechanism how these may be converted into the same currency.[7]

Another netting technique developed by the market is *novation netting* whereby two or more contracts of the same type are terminated and replaced by a new contract of exactly the same kind of obligations that mirrors only the net balance of the terminated contracts and which is to be performed at a future date. Alternatively, each contract may provide for its automatic consolidation with subsequent contracts as and when these come into existence. Since it is necessary that the novated obligations are of the same kind, where mutual dealings involve both delivery and payment obligations, it is necessary to devise a contractual procedure by which one type of obligation can be converted to the other. Similarly, if both obligations are not in the same currency, it is necessary that one currency is converted to the other or that both currencies are converted to a third currency at a given rate of exchange.[8]

6 See, for instance, Section 2(c) of the 2002 ISDA Master Agreement.
7 HUDSON (2018) 17-34.
8 Hudson considers that the ISDA Master Agreement (both 2002 and1992 versions) seeks to circumvent the requirements of novation, *i.e.* that a single executory contract replaces all previous existing contracts, by declaring in Section 1(c) that 'all separate transactions form part of a "single agreement" from the outset'. See HUDSON (2018) 17-33.

Close-out netting is a mechanism which extends to a group of financial obligations concluded under a netting arrangement and provides, upon the occurrence of a pre-defined event, for the acceleration and termination of unperformed obligations and the calculation of a close-out net amount determined in accordance with a valuation mechanism. Its scope is to reduce exposures on open contracts still to be performed by both parties if one party defaults on its obligations or becomes insolvent. There are two types of close-out netting arrangements: those which impose two-way payments and those which allow the non-defaulter to 'walk away'. Under a two-way payment arrangement, the non-defaulter or, where the event of default relates to an intervening insolvency, the solvent counterparty agrees to fully honour any payments due by itself under the netting arrangement and to pay any net amount owed to the insolvent counterparty following the calculation of a close-out amount. If the solvent counterparty can benefit from a 'walk away' clause, this implies that the netting arrangement permits the solvent counterparty to suspend, modify or extinguish its obligations to make payments to the insolvent party. Thus, the solvent counterparty may, as a result of this clause, not pay any net balance in favour of the insolvent counterparty.[9]

The *global or cross-product netting* technique provides for the netting of two or more close-out amounts of different products which might have been calculated using different close-out netting techniques possibly under different netting agreements. The aim of cross-product arrangements is to render it possible to link flows of cash relating to different types of financial products. It is necessary in this scenario that upon the occurrence of an event of default, the parties terminate their various product-specific agreements at the same time in order to pay only a single net sum in respect of the combined close-out amounts. According to Keijser, there are at least three ways of connecting different financial arrangements in order to permit the netting of mutual obligations between the parties arising under those arrangements.[10] The first is the so-called 'bridge provision' approach whereby the cash and securities under different agreements can be connected by including a clause in one or more agreements that refers to the other agreements. This type of global netting is used by the 2001 ISDA Cross-Agreement Bridge. The second is the possibility to document different financial products under a single master agreement as in the case

9 Parties may not rely on walk-away clauses if they wish to take advantage of close-out netting for the purposes of calculating required capital under the regulatory capital adequacy standards of the Basel Agreement. See BCBS 2006 Standards, Annex 4, para 96(iii). The walk-away clause, although it may affect the payment to the insolvent party following the application of a close-out netting provision, is not strictly speaking part of the close-out netting mechanism and is not generally protected as part of the close-out netting provision. See UNIDROIT 2013 Close-out Netting Principles 18.

10 KEIJSER (2006) 40.

of the 2004 European Master Agreement[11] sponsored by the Banking Federation of the European Union,[12] the European Savings Banks Group[13] and the European Association of Cooperative Banks.[14] The third is the 'master master agreement' approach whereby the parties conclude several master agreements to document different financial transactions and a separate agreement, *i.e.* the master master agreement, links the close-out mechanisms of the respective master agreements for different financial products. This technique is found in the 2000 Cross-Product Master Agreement which is a joint product of various trade associations.[15]

Finally, two ancillary types of netting techniques, namely *multibranch netting* and *multilateral netting*, may be used in combination with any of the other netting techniques described above. Under *multibranch netting*, a netting agreement may extend to the entirety of financial contracts entered into with the same counterparty by the head office and its foreign branches since they form part of the same legal corporation.[16] However, if a multi-branch party becomes insolvent, the feasibility of multi-branch netting will depend on whether there is a single insolvency proceeding covering both the head office and the branches governed by the national insolvency law of the head office, or whether there are separate proceedings over some or all of the branches. In the latter case, the local insolvency practitioner may ring-fence the claims and assets of the branch from being attributed to the head office estate or the estate of another branch.[17]

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11 The official name of this master agreement is the Master Agreement for Financial Transactions. In terms of the 2001 Explanatory Memorandum to the 2001 version of this master agreement, this agreement is commonly referred to as the European Master Agreement (EMA).

12 The Banking Federation of the European Union or, as it is known, the European Banking Federation, (EBF) is committed to create a single market for financial services in the EU and to support policies that foster economic growth. See the BFE's website at < http://www.ebf-fbe.eu/>.

13 The European Savings Bank Group (ESBG) represents the interests of its members vis-à-vis EU institutions by taking positions in matters related to the EU financial services policies and it also fosters cooperation among its members. See the ESBG's website at < http://www.savings-banks.com/>.

14 The European Association of Cooperative Banks (EACB) represents and promotes the interests of its member institutions and cooperative banks in respect of banking and cooperatives legislation. It also develops common positions on European banking policies. See the EACB's website at < http://www.eacb.coop/en/home.html>.

15 These are the Bond Market Association, the British Bankers' Association, the Emerging Markets Traders Association, the Foreign Exchange Committee, the International Primary Market Association, ISDA, the Japan Securities Dealers Association, the London Investment Banking Association and the Investment Dealers Association of Canada.

16 Wessels notes that since foreign branches or representative offices form a single legal unit with the parent company, the mutuality of debts and claims which is required in netting subsists. WESSELS (1997) 192.

17 WOOD (2007) 95; UNIDROIT 2011 Close-out Netting Report 15.

Multilateral netting, on the other hand, regards the netting of obligations among separate legal entities (as opposed to multibranch netting which concerns netting among branches of one single corporation). The term is sometimes used loosely to describe central clearing. In the strict sense it applies to the specific situation where financial market participants of a payment system compute their mutual exposures on a multilateral basis whereby claims existing on a bilateral basis are replaced by net claims calculated on a multilateral basis, connected by a series of mutual cross-assignments or cross-guarantees.[18] In this case netting is used as a tool to circumscribe the exposure of one market participant vis-à-vis a multitude of other independent market participants. This technique may be used also to manage risk exposure of several separate legal entities belonging to the same group of companies, which is at times referred to as 'cross-affiliate netting'.[19]

Advantages and Disadvantages of Netting

There are a number of benefits, mainly of a risk-mitigating nature, accruing from the use of netting which may have instigated its development by the market. These advantages are at times postulated to justify the derogations granted to netting arrangements from the application of insolvency and other laws. However, especially in the aftermath of the recent financial crises, a number of disadvantages have also been voiced. Below is a brief description of the more frequently cited advantages and disadvantages in relation to netting. This part is intended to lead to an appreciation of the global movement which led various legislators to grant recognition to close-out netting provisions which, as will be seen in Chapter 2, may not have been possible to enforce on account of, *inter alia*, national insolvency laws.[20]

The main advantages accruing from netting techniques are the following.

(i) Reduction of exposures and counterparty risk. Netting techniques in general serve to reduce counterparty credit risk by reducing the amount of cash flow between the parties to a net amount.[21] Counterparties would therefore need to assume net as opposed to gross exposure, as the relevant

18 *Ibid.* 16.

19 The application of multilateral netting is not free from legal problems. Multilateral netting agreements are highly complex and the recognition of a multilateral netting agreement by the applicable national insolvency law depends on whether multilateral netting is legally recognised. In addition, to the extent that cross-assignments are only agreed on an *ad hoc* basis in the event of default of one of the parties, the insolvency administrator may subsequently avoid these agreements as unjustified preferences. These legal problems have, in fact, contributed to the increasing use of central clearing facilities. *Ibid.*

20 It is to be noted from the cited references below that most of the advantages have been announced by ISDA or by associations in which ISDA is, or was, an active participant.

21 UNIDROIT 2011 Close-out Netting Report 17.

measure of counterparty risk. For instance, close-out netting counteracts credit risk as it avoids the potential situation where the non-defaulting party would be required to honour all transactions favourable to the insolvent estate in case of insolvency of the counterparty while foregoing all transactions which are favourable to itself if the insolvency practitioner chooses to resort to so-called 'cherry-picking' powers available under insolvency law.[22]

(ii) Enhanced Risk Management. Counterparties are normally able to mitigate market risk represented in the fluctuating value of financial transactions such as OTC derivatives by maintaining hedging transactions with third parties whose value will fluctuate inversely to that of their debtors' transactions. By maintaining a so-called 'matched book' of offsetting transactions, counterparties seek to neutralise unwanted exposures to movements in various interest rates, maturities, currencies, prices and other sources of market risk.[23] In a close-out netting situation, there is also a credit risk dimension to the matched book. If a party is insolvent, the solvent party's formerly hedged transactions are now open exposures and it may become vulnerable to losses if the market were to move in an adverse direction on those transactions. Termination under a close-out netting provision enables it to opt for the early resolution of claims and therefore to crystallise its position or to replace relevant transactions and bring its matched book back into balance.[24]

(iii) Systemic Stability. Perhaps the most important argument in favour of netting techniques is that these may reduce systemic risk. This risk may arise either as a result of direct exposures (so-called 'rational contagion') or through changes in risk perceptions unrelated to actual exposures ('irrational contagion').[25] It has been stated that financial contracts such as OTC derivatives contracts are particularly vulnerable to systemic shocks.[26] The argument is that derivatives markets cannot function if stays are imposed by national insolvency laws since this would lock counterparties into long-term derivatives positions of rapidly changing value in case of the failure of a derivatives dealer. The close-out netting technique therefore enables solvent counterparties to quickly resolve derivatives positions and to reduce their risk by assuming net and not gross positions, thereby minimising the contagion effect.[27]

(iv) Reduction of Capital Requirements. Banking supervisors have generally recognised the risk-reducing effect of netting techniques and, provided that credit institutions can rely on legally enforceable netting agreements, they can calculate capital requirements on the basis of net, rather than gross,

22 *Ibid*. The notion behind the 'cherry-picking' powers of the insolvency administrator will be discussed in Chapter 2.1.1.

23 MENGLE (2010) 6.

24 *Ibid.*

25 BERGMAN *et al.* (2004) 30.

26 *Ibid.*

27 *Ibid.* 32.

exposure. An important declaration to this effect was made in a report of the Basel Committee on Banking Supervision (BCBS) on International Convergence of Capital Measurement and Capital Standards (the so-called Basel II Accord) published in June 2004.[28] The Basel II Accord allows credit institutions to net certain exposures, including stipulated cross-product exposures, such as loans and deposits and 'repo-style' products, as the basis for their capital adequacy calculation, provided certain conditions listed in Paragraph 188 of the Accord are met. Among these conditions is that the bank should have 'a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction'. In the EU the consideration of on-balance sheet netting in respect of loans and deposits, repurchase transactions, securities or commodities lending transactions, and a number of OTC derivatives is given the same favourable treatment under Articles 205 and 206 of Regulation (EU) No 575/2013 of prudential requirements for credit institutions and investment firms.[29] As a result of these rules, legally binding netting techniques can reduce the capital adequacy cost (i.e. the cost of capital required to be held by a credit institution against its risks) since the calculation of capitalisation may be based on net credit exposure as this is taken to represent the actual total loss which may be suffered in the event of default.[30]

(v) Enhanced Market Liquidity. As a consequence of the fact that legally enforceable netting techniques allow counterparties to assume only net exposures for regulatory capital requirements, credit institutions will have more liquidity available for lending or investment, and will also reduce the amount of assets which would otherwise need to be blocked under collateral arrangements, thereby also reducing transactions costs (e.g. the costs of managing credit lines and collateral).[31] This advantage has led to the exploitation, to the extent legally permitted, of settlement netting since counterparties are enabled to expand on their gross positions while limiting their net exposures, resulting in increased market liquidity for a given level

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28 BCBS 2006 Standards, paras 117, 118, 139, 188.

29 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, [2013] OJ L 176/1. This rule was first contained in Directive 96/10/EC of the European Parliament and of the Council of 21 March 1996 amending Directive 89/647/EEC as regards recognition of contractual netting by the competent authorities [1996] OJ L 85/17.

30 UNIDROIT 2011 Close-out Netting Report, 18. But see in this respect the limitation imposed by the ECB in ECB SSM Letter to Significant Institutions (2019) that the benefit from the reduction of capital requirements '[…] is without prejudice to the competence of the ECB to conduct any follow-up investigations and to decide that a particular bilateral netting agreement, or a particular type of bilateral netting agreement, or a netting agreement with a particular counterparty or with a particular type of counterparty, is not to be recognised as risk-reducing', thereby creating an element of uncertainty on the reliance on bilateral netting arrangements.

31 *Ibid.* 19.

of capital.[32] This would free up funds, thereby increasing overall market liquidity.

A number of disadvantages relating to netting techniques have also been identified, mainly following the financial crisis of 2008-2009. Depending on the applicable jurisdiction and the influences of its legal system, these disadvantages could have influenced, in varying degrees, the national statutory recognition given to close-out netting. In such instances, national legislators may either have decided to introduce fairness, equitable or other considerations when granting recognition to this concept or could have proceeded to strike a balance of the interests involved when granting such recognition. The most frequently cited disadvantages are the following.

(i) Shifting Risk on other Creditors. Where national law shields netting arrangements from the application of insolvency law so that these are enforceable in the event of insolvency, their operation leads to moving the counterparty risk to those of the insolvent's other creditors who are subject to insolvency stays, in particular if their claims are not collateralised.[33] In certain jurisdictions, the law imposes a stay or freeze on pre-insolvency claims made after the opening of insolvency procedures and allows 'cherry picking' by the insolvency practitioner, both of which serve to enhance the value of the insolvent estate for the general benefit of creditors. To the extent that the close-out netting technique is enforceable, claims and assets are not drawn into the insolvent estate, with the result that fewer assets are available for distribution to the unsecured creditors of the insolvent estate with adverse implications to the *pari passu* principle to be outlined in Chapter 2.

(ii) Encourages Moral Hazard. Netting may reduce the incentives of market participants to monitor counterparty risks and to limit their risk-taking appropriately. The argument is that on account of the shifting of risk referred to above, the post-insolvency transfer of losses from one creditor group to another affects the *ex ante* behaviour of counterparties that may benefit from netting. Thus, the resort to netting might lead to increased exposure prior to default and therefore to higher losses if default occurs.[34]

(iii) Potential for Systemic Risk. If a major counterparty experiences financial difficulties and starts to default on the performance of its obligations, and its counterparties decide on a simultaneous exercise of close-out netting, the end result could be that there are shock effects in the market through the forced liquidation of assets.[35] Since large market participants have multiple counterparties, the situation in the above circumstances is likely to be extremely unstable. Once one counterparty enforces its close-out rights, a 'rush for the exit' may develop where counterparties will seek to liquidate their own positions before the actions of others depress prices (the

32 BLISS (2002) 52; HUDSON (2018) 17-13.
33 PAECH (2010) 15.
34 BERGMAN *et al.* (2004) 32.
35 BCBS 2010 Recommendations, Recommendation 9.

so-called 'fire sale' effect) and their own losses increase.[36] The consequence would be a self-amplifying cycle of terminations and liquidations that would lead to more general market disruption and loss of confidence.

(iv) Pre-emption of Regulatory Intervention. Banking regulation frequently seeks to resort to the rescue of credit institutions by becoming involved in a credit institution's activities as it approaches insolvency. These plans for preventing a credit institution from becoming insolvent presume that the decline in a credit institution's condition will be observable and sufficiently gradual to permit timely intervention. Prompt corrective action cannot work when perceived asset values change rapidly as when they are suddenly realised as a result of the exercise of close-out netting rights.[37] In cases where close-out is exercised by a number of counterparties of the failing credit institution, the latter may be so distressed as to make reorganisation impracticable.

In the aftermath of the recent financial crises, the Cross-border Bank Resolution Group of the BCBS criticised the potential negative repercussions brought about by automatic or post-insolvency enforceability of netting agreements in times of pressure on the financial market.[38] The BCBS expressed concern that the initiation of formal resolution or insolvency procedures could trigger the simultaneous closing out of large volumes of financial contracts which could destabilise markets and undermine the orderly resolution of failing institutions. It recommends that in order to better protect financial stability, it would be preferable to transfer the debtor's financial contracts to a solvent third party, a bridge bank or similar entity and to wind the insolvent entity down in an orderly fashion. The BCBS therefore recommends introducing powers for national regulators (i) to delay automatic close-out and termination for up to forty-eight hours in order to allow a decision on whether the distressed party's financial contracts should be transferred to a solvent institution, and (ii) to effect such a transfer of contracts, under certain conditions.[39] As noted in the Introduction, similar recommendations for a temporary stay of the exercise of close-out netting rights have been made by the FSB[40] and these have been implemented in a number of jurisdictions such as in the EU and the US.

The first part of this chapter was intended to provide background understanding of the various netting techniques, including close-out netting, as developed under the *lex mercatoria,* and to explain the motives which may have led legislators to adopt netting laws, both to grant recognition to close-out netting provisions and also to curtail this recognition in view of financial stability goals pursued by bank resolution regimes. In the next part, a conceptual analysis is made of the constitutive elements of

36 BLISS (2003) 56; SOLTYSINSKI (2013) 431.
37 BLISS (2003) 56.
38 BCBS 2010 Recommendations, Recommendation 9, p 40.
39 *Ibid.* 42.
40 FSB 2011 Key Attributes, Section 4, p 10.

close-out netting which will enable an initial comparison to be made with the concept of set-off in the preliminary conclusions of this chapter.

1.1.1 The Constitutive Elements of Close-out Netting

Arguably, the unique feature of close-out netting which distinguishes it from the other netting techniques is the faculty given to the non-defaulting party to proceed to the early termination of financial transactions upon the occurrence of a pre-defined event of default such as insolvency. Other features such as the possibility of valuing non-monetary obligations or to convert foreign currency obligations in order to achieve same currency monetary amounts are, to some degree, shared with the other netting techniques. The faculty to terminate transactions gives close-out netting the characteristic of a remedy since it is only applicable upon a default or change in circumstance, and comes into operation only upon the occurrence of either a declaration of one party where a termination event, as defined in the relevant netting agreement, materialises or it is triggered automatically when such event occurs.[41] An analysis of some definitions of close-out netting may shed more light on the parameters of this technique as it has been developed by the market.

An important definition of a close-out netting provision from an EU perspective is that contained in Article 2(1)(n) of the EU Financial Collateral Directive which defines a close-out netting provision in the context of a financial collateral arrangement whereby upon the occurrence of an enforcement event 'the obligations of the parties are accelerated […] or are terminated and replaced by an obligation to pay such an amount' and 'a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party'.[42]

In the same vein, the UNCITRAL Guide defines close-out netting under its definition of netting as follows: 'the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other'.

41 Indeed, according to Peeters, the operation of close-out netting resembles the way termination for breach is settled under many systems of law, *i.e.* by the payment of damages by the defaulting party, but with one important difference which gives close-out netting a novel aspect: the close-out netting process may lead to the result that the non-defaulting party must pay the close-out amount to the defaulting party. PEETERS (2014) 63.

42 This definition is replicated in Article 2(1)(98) of the EU Bank Recovery and Resolution Directive and in the UNIDROIT Convention on Substantive Rules for Intermediated Securities (as revised on 25 September 2013). This Convention was adopted at a diplomatic conference in Geneva on 9 October 2009. The main purpose of the Convention is to offer harmonized transnational rules for the purpose of reducing the legal risks associated with the holding of securities through intermediaries.

A more comprehensive definition is provided in Principle 2 of the UNIDROIT Principles in terms of which upon the occurrence of a pre-defined event obligations owed between the parties 'are automatically or at the election of one of the parties reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other.' The UNIDROIT definition is expressly drafted in general terms so as to encompass different types of close-out netting provisions which aim to achieve functionally a similar economic result and which is neutral as to the legal methods by which these results may be achieved.[43]

These definitions of close-out netting appear to converge on the steps involved in the close-out netting process, namely (i) termination of the transactions or obligations subject to the relevant close-out netting provision following a trigger event, (ii) valuation in monetary terms of the closed-out transactions or obligations[44] and (iii) determination of a net balance (sometimes called the netting proper).[45] Each of these steps will be briefly described below. The practical application of these steps is considered in the analysis of the close-out netting provisions of two selected master agreements made at the end of this chapter. The analysis of these steps will serve in Chapter 7 to compare close-out netting with the classic concept of set-off to determine whether conceptually close-out netting may be considered as an off-shoot of set-off or whether close-out netting is an independent concept developed by the financial market.

In the *termination* phase the non-defaulting party closes all outstanding obligations normally through an acceleration of the maturity periods. Acceleration refers to the situation where an obligation becomes due and payable before the contractually agreed date. Termination as a functional mechanism extends to a number of open transactions between the parties

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43 UNIDROIT 2013 Close-out Netting Principles, 10.

44 The valuation element is sometimes implied, rather than expressed, as in the case of the FCD definition.

45 This three-step approach is confirmed by various authors. See ANNETTS & MURRAY (2012) 269; PEETERS (2014) 59; ISDA 2010 Research Note, 3; DERHAM (2010) 761; LOIZOU (2012) 430; VIRGóS & GARCIMARTíN (2014) 153; MENGLE (2010) 3. The UNIDROIT Report on 'The need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution' splits the early termination and acceleration into two different elements so that in terms of this Report close-out netting has four functional elements, namely termination, acceleration, valuation and computation of a net amount. See UNIDROIT 2011 Close-out Netting Report, 27. The UNCITRAL Legislative Guide, on the other hand, states that close-out netting involves two steps: firstly, termination of all open contracts as a result of the commencement of insolvency proceedings (close-out) and, secondly, the set-off of all obligations arising out of the closed-out transactions on an aggregate basis (netting). See UNCITRAL Legislative Guide (2004), para 210. This research follows the more accepted view that close-out netting is composed of three constitutive elements and amalgamates the termination and acceleration elements into one step.

which are covered by the relevant close-out netting arrangement and are outstanding upon the occurrence of a pre-defined event, as in the case of a default or the insolvency of the counterparty. Termination is a right given to the non-defaulting party typically exercised by notification given to the other party upon the occurrence of a pre-defined event.[46] The termination may relate to obligations under more than one financial contract which are, for instance, linked by a master-master netting agreement. In such a case, whilst the unsettled financial contracts may be terminated, the netting agreement itself should not be terminated for the close-out netting agreement to function properly.[47]

In the *valuation* phase the method of determining the value of each transaction being terminated is, unless otherwise restricted by national law, executed in accordance with the calculation mechanism stipulated in the netting contract of market value or replacement cost of the terminated transactions. The valuation phase aims to transform the outstanding obligations, which may be either payment or delivery obligations such as obligations to deliver securities or commodities, into obligations of monetary value using the methods pre-defined in the netting agreement such as the replacement value of the transactions or the market value of the closed obligations. Under the pre-defined valuation mechanism, the value of the closed-out transactions is aggregated and determined in a single currency.

In the *determination of the net balance*, the positive values, i.e. those due to the non-defaulting party, and the negative values, i.e. those due from the non-defaulting party, are netted against each other in order to determine a final close-out amount. The determination of a net balance is the 'pure' netting phase in the close-out netting process[48] and involves the calculation of losses and gains over the whole series of mutual transactions and their aggregation to form a single net amount. This aggregation of values thus reduces the various obligations arising under the individual transactions into one single payment obligation which is due by one party to the other.

46 According to the UNIDROIT Principles, it is a matter of concern if the non-defaulting party is able to suspend the exercise of its close-out rights in particular when it is out-of-the-money and is entitled not to make any payments to the defaulting party after the occurrence of the event of default. The non-defaulting party may therefore, through inaction, avoid having to perform its obligations. See UNIDROIT 2013 Close-out Netting Principles, 18. An attempt has been made by ISDA to resolve this eventuality under the ISDA Master Agreements by the adoption of an Amendment to both the 1992 and 2002 ISDA Master Agreement introducing the concept of the 'Condition End Date' which requires the non-defaulting party at the end of a specified period (the Condition End Date) either to elect to make its scheduled payments or deliveries and continue the contract or otherwise designate an Early Termination Date. This is meant to provide a remedy to the defaulting party against the effects of Section 2(a)(iii) of the ISDA Master Agreement which contains a condition relieving the non-defaulting party of its obligation to make payment or delivery to the defaulting party if an event of default or potential event of default has occurred and is continuing. See GURNEY (2014) 521.

47 UNIDROIT 2011 Close-out Netting Report, 73.

48 See PEETERS (2014) 59.

The same result may be achieved through novation when the parties agree that upon termination of all open transactions, a new obligation arises representing the relevant aggregate value of the old obligations.[49] In the case of insolvency, if this net amount is negative for the solvent party (*i.e.* the resulting net balance following the calculation of the final close-out amount is due to the insolvent party so that transactions are 'out the money' for the solvent party), the solvent party must pay unless a walk-away arrangement applies. If the resulting net amount is positive for the solvent party (so that transactions are 'in the money' for the latter), the solvent party will not pay but becomes general creditor up to the amount of the net balance, if not covered by collateral and unless national insolvency law contains its own mechanism for dealing with the close-out amount.[50]

According to the explanatory text to the definition of a close-out netting provision under Principle 2 of the UNIDROIT Principles, the functioning of the netting mechanism comprising the termination of transactions, acceleration of obligations, valuation of the transactions, and aggregation of the result in an overall net amount may vary in sequence depending on the actual close-out netting provision. Moreover, it is not always necessary that all these elements are present in order to achieve the functional result of close-out netting, *i.e.* the single net payment obligation.[51] This versatility is an indication of the way in which close-out netting has developed, *i.e.* a flexible market tool to suit the needs of the financial community.

1.1.2 Close-out Netting Provisions in Master Agreements

Having considered the three constitutive elements of close-out netting in the previous part, in this part the application of these constitutive elements will be illustrated by examining the close-out netting provisions of two standard master agreements. This analysis will also serve to provide an understanding of the diverse ways in which the financial market has developed the concept of close-out netting under the *lex mercatoria* to suit the purposes and context of the product market in which it operates.

The close-out netting process forms the core element of two important standard master agreements used by market participants, namely the so-called Global Master Repurchase Agreement (GMRA) used in the repurchase market and the ISDA Master Agreement used in relation to derivatives transactions.[52] The basic principle sustaining these agreements is that the obligations they govern form a bundle that should not be dismantled in

49 UNIDROIT 2013 Close-out Netting Principles, 16.
50 PAECH (2014) 425.
51 UNIDROIT 2013 Close-out Netting Principles, 15.
52 The ICMA Global Master Repurchase Agreement available at < http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/global-master-repurchase-agreement-gmra/>; and the ISDA Master Agreements of 1992 and 2002 available at < http://www.isda.org/publications/isdamasteragrmnt.aspx>.

order to make it possible for the aggregate value of all unperformed obligations to be computed and converted into one single (net) payment obligation.[53] These two master agreements have been selected for two reasons.[54] First, the ISDA and GMRA agreements are probably the most frequently used agreements in the derivatives and repo markets. Secondly, they resort to two different types of close-out netting processes which serve to show the versatility of this mechanism. In brief, the GMRA foresees the acceleration of the maturities of all transactions so that the parties' obligations fall due immediately. The ISDA master agreement provides for the extinguishment of obligations and the calculation of replacement values. Each of these methods is examined in more detail below.

1.1.2.1 2002 ISDA Master Agreement

The 2002 ISDA master agreement is an update of the 1992 version. The ISDA master agreement may, at the election of the contracting parties, be governed by English or New York law. The close-out netting provision is found in Section 6 under the heading 'Early Termination; Close-Out Netting'.

The termination phase is constituted under Section 6 of the 2002 ISDA master agreement. Upon the occurrence of an event of default such as the opening of insolvency proceedings in relation to one of the parties, Section 6(a) stipulates that the non-defaulting party may designate an early termination date for all outstanding transactions, unless automatic early termination applies. As stated, the early termination of derivatives takes the form of extinguishing outstanding obligations upon the occurrence of an event of default. This extinguishment is provided by Section 6(c)(ii) of the ISDA agreement, in terms of which:

> 'Upon the occurrence or effective designation of an Early Termination Date, no further payments or deliveries […] in respect of the Terminated Transactions will be required to be made […].'

The valuation phase is constituted under Section 6(e) of the agreement. The valuation is based on the non-defaulting party's calculations of replacement losses, costs or gains in respect of terminated transactions in order to enable the non-defaulting party to obtain the economic equivalent of the material terms of the terminated transactions.

The determination of the net balance is provided under Section 6(e)(i) whereby the close-out amount consists of the following: (i) payments for the future replacement value of terminated transactions calculated by the non-defaulting party in reaching the close-out amount; (ii) contractual payment

53 PAECH (2010) 22.

54 For a more general discussion of the differences in close-out provisions of a number of master agreements, see EFMLG 2010 Symposium Report.

or delivery obligations due under Section 2(a)(i)[55] which were due before the early termination date but not paid, *i.e.* the unpaid amounts; and (iii) payments or deliveries which would have been due before the early termination date if all conditions precedent, such as no event of default having taken place, had been satisfied or if the early termination date had not been designated. These amounts are referred to under Section 2(a)(iii)[56] and also form part of the unpaid amounts. The close-out amount is arrived at by adding the net termination currency equivalent of the close-out amount calculated by the non-defaulting party for all terminated transactions and the termination currency equivalent of the unpaid amounts due to the non-defaulting party, and deducting therefrom the termination currency equivalent of the unpaid amounts owing to the defaulting party. Calculations must be carried out in good faith and according to commercially reasonable procedures. Close-out amounts are calculated as of the early termination date or if this is not commercially reasonable as of the next commercially reasonable date.[57]

In the final stage, if the resulting close-out figure is a positive number, the defaulting party pays it to the non-defaulting party. If it is a negative figure, the non-defaulting party pays it to the defaulting party. In addition, Section 6(f) provides that when there is an event of default and there is only one affected party (as in the case of insolvency of one of the parties), any early termination amount payable may, at the non-defaulting party's option without notice, be reduced by setting off against any other amount payable under other arrangements by the payee to the payer.[58]

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55 In terms of Section 2(a)(i): 'Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.'

56 In terms of Section 2(a)(iii): 'Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other condition specified in this Agreement to be a condition precedent for the purpose of this Section 2(a)(iii).' According to Dalhuisen, this conditionality created by Section 2(a)(iii) gives rise to the notion of a 'flawed asset' which is used by the ISDA agreement to create an alternative to set-off which is not constrained by limitations that may be inherent in insolvency set-off. This flawed asset theory is based on the notion that a flawed asset is created which upon an event of default is replaced by the early termination amount. See DALHUISEN (2019) Volume 3, 404.

57 See in this respect the definition of Close-out Amount in Section 14 of the agreement. In determining the close-out amount the determining party may consider any relevant information including firm or indicative quotations for replacement transactions or relevant market data such as relevant rates, prices, yields, yield curves, volatilities, etc. obtained from one or more third parties or, otherwise, from internal sources if such information is regularly used in the course of its business for the valuation of similar transactions. The non-defaulting party may include costs of funding provided they are not already included in the information or quotations obtained, and it may also add any hedging unwind costs in connection with the terminated transactions to the close-out amount or it can deduct any hedging gains.

58 HARDING (2004) 245.

A recent development which, depending on national law, may affect the termination phase of the close-out netting mechanism of the ISDA master agreements relates to the launch by ISDA in 2014 of a new ISDA Resolution Stay Protocol developed in coordination with the FSB with the intention to support cross-border resolution and reduce systemic risk.[59] This was replaced a year later by the ISDA 2015 Universal Resolution Stay Protocol (the Protocol)[60] which extended the application of the 2014 Protocol to other agreements in addition to the ISDA master agreements covered by the Securities Financing Transaction Annex.[61] Parties adhering to the Protocol agree that they will only exercise their so-called 'Default Rights' against each other to the extent permitted under the national special resolution regimes to which they may be subject. Default rights are widely defined in Section 6 of the Attachment to the Protocol as referring to rights 'to liquidate, terminate or accelerate such agreement or transactions thereunder, set off or net amounts owing in respect thereto (except rights related to same-day payment netting), exercise remedies in respect of collateral or other credit support related thereto, demand payment or delivery thereunder or in respect thereof…' In this way the restrictions imposed by different special resolution regimes are transposed into the Protocol and will serve to give precedence to the *lex fori concursus* or the *lex fori resolutionis* over the *lex contractus* if the two laws do not coincide.[62] The 2015 Protocol was complemented by the ISDA Resolution Stay Jurisdictional Modular Protocol which became effective on 3 May 2016 and is intended to grant contractual recognition to the application of termination rights under the home-country resolution regimes. A specific ISDA 2018 US Resolution Stay Protocol, effective on 31 July 2018 and updated on 10 June 2019, was also adopted based on the requirements of the so called 'US Stay Regulations' for globally important systemic banks.[63]

59 See ISDA News Release entitled 'Major Banks Agree to Sign ISDA Resolution Stay Protocol' (October 11, 2014). The Protocol was published on 4 November 2014 and became effective on 1 January 2015.

60 The 2015 Protocol was published on 4 November 2015 and became effective on 1 January 2016.

61 In terms of Section 1 of this Annex, the agreements covered are the Global Master Repurchase Agreement, the Global Master Securities Lending Agreement, the Master Equity and Fixed Interest Stock Lending Agreement, the Master Gilt Edged Stock Lending Agreement, the Master Repurchase Agreement, the Master Securities Loan Agreement, and the Overseas Securities Lender's Agreement.

62 For a conflict of law analysis of the effect of national or EU resolution measures on parties to a close-out netting agreement, see VIRGóS & GARCIMARTíN (2014) 156 *et seq*.

63 See 12 C.F.R. §§ 252.83-84; 12 C.F.R. §§ 382.3-4; 12 C.F.R. §§ 47.4-5.

1.1.2.2 2011 Global Master Repurchase Agreement

The 2011 GMRA is an enhanced version of the 2000 GMRA. This agreement is governed by English law. The close-out netting provision of the 2011 GMRA is incorporated in paragraph 10 entitled 'Events of Default'.

In relation to the termination phase, paragraph 10(b) of the 2011 GMRA provides that if an event of default has occurred or is continuing, the non-defaulting party may, by giving not more than twenty days' notice, designate an early termination date in respect of all outstanding transactions unless the parties have selected automatic termination to apply. All outstanding transactions are deemed terminated either on the early termination date designated by the non-defaulting party or, in case of insolvency, upon the occurrence of certain insolvency events such as the presentation of an application for winding up.

The close-out provision under the GMRA is based on the acceleration of outstanding transactions, whereby delivery obligations in respect of securities are converted to cash sums based on the market value of those securities.[64] This is provided in paragraph 10(c) of the 2011 GMRA agreement:

> 'If an Early Termination Date occurs, the Repurchase Date for each Transaction hereunder shall be deemed to occur on the Early Termination Date and, subject to the following provisions, all Cash Margin (including interest accrued) shall be repayable and Equivalent Margin Securities shall be deliverable and Cash Equivalent Amounts shall be payable, in each case on the Early Termination Date…'

Under the valuation phase, the non-defaulting party calculates the close-out amount by reference to an actual sale or purchase price or, in the discretion of the non-defaulting party, by reference to the market value of the securities derived from quotations obtained from market participants at the time of the early termination date. A combination of valuation is also possible in case the actual sale or purchase is not possible for the whole amount of the securities. If the non-defaulting party has not managed to sell or purchase securities or to obtain quotations or has determined that it is not commercially reasonable to do so, it may instead determine the market value to be the so-called 'Net Value' of the securities. This refers to the fair market value reasonably determined by the non-defaulting party and derived from pricing sources such as trading prices or based on pricing methods considered appropriate by the non-defaulting party, less transaction costs which would be incurred or reasonably anticipated in connection with the purchase or sale of such securities. All amounts are to be converted into the contractually agreed 'Base Currency'.

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64 This type of close-out netting is referred to by Peeters as 'the set-off of accelerated and converted obligations'. PEETERS (2014) 60.

The defaulting party is also liable for any losses, damages, costs or expenses incurred by the non-defaulting party as a result of the event of default. These may include legal costs, costs of acquiring replacement securities and costs related to the entry or termination of any hedging transactions. Interest is due by the defaulting party on any amounts not promptly paid to the non-defaulting party.

Finally, in relation to the determination of a net balance, since all accelerated and converted obligations are now commensurable netting may be affected by setting off these obligations to determine the termination amount as well as the party that must pay this amount. This is provided in paragraph 10(d)(ii) as follows:

> '…an account shall be taken (as at the Early Termination Date) of what is due from each party to the other under this Agreement … and the sums due from one party shall be set off against the sums due from the other and only the balance of the account shall be payable (by the party having the claim valued at the lower amount pursuant to the foregoing)…'

As with the 2002 ISDA master agreement, paragraph 10(n) the 2011 GMRA provides for 'cross-agreement' netting so that the close-out amount payable by one party to the other following an event of default may, at the option of the non-defaulting party, be set off against any amount payable by the payee to the payer under any other agreement between them.

ICMA published on 12 November 2015 a Securities Financing Transaction Annex that forms part of the ISDA 2015 Universal Resolution Stay Protocol intended to instigate compliance with relevant bank resolution laws requiring the recognition of bank resolution stays in certain cross-border contractual arrangements.

1.2 Evolution from the Concept of Set-off

Although close-out netting is a relatively novel term, it is deemed that the netting technique combines pre-existing, often much older, legal concepts, and the innovative aspect of close-out netting is found predominantly in the specific combination of these classical concepts and techniques and their adaptation to financial market practice.[65]

According to the UNIDROIT Principles, close-out netting may be considered to have principally evolved from the classic concept of set-off applied upon default or insolvency of one of the parties.[66] Set-off, being the discharge of reciprocal obligations to the extent of the lesser obligation, is typically considered as a form of payment.[67] This convenient way to settle

65 PEETERS (2014) 56.
66 UNIDROIT 2013 Close-out Netting Principles, 2.
67 WOOD (2007) 4; DALHUISEN (2019) Volume 3, 386.

dues is particularly important in the case of insolvency of one of the parties as the set-off generally allows the solvent party to reduce its own claim by any amount it owes to the insolvent party so that the former will be a competing creditor under insolvency rules only for the excess indebtedness, if this arises. This right given to the creditor may, depending on national law, operate either automatically or at the election or notification by the solvent party. According to Dalhuisen, in those instances where a notification or election requirement is necessary, set-off is considered a legal act which is subject to party autonomy so that parties are at liberty not to resort to set-off or to impose additional requirements or to extend the facility.[68]

UNIDROIT notes that certain requirements which need to be fulfilled by classical set-off, however, may render this technique ineffective in the financial markets. Thus, traditional set-off would typically apply only to obligations that are due, and not to obligations which need to be performed in the future. Set-off could be restricted to obligations arising under the same agreement or to obligations, being only payment obligations, of the same kind.[69] The close-out netting technique has thus been developed by the market through its contractual arrangements to bypass these requirements, in particular (i) to do away with the connexity requirement to encompass obligations across various financial contracts under the close-out netting provision, (ii) to permit the acceleration of maturity of obligations, and (iii) to render possible the set-off of non-monetary obligations (as in the case of delivery of commodities or investment securities) or of obligations in different currencies through a valuation mechanism agreed in the netting contract.[70]

The problem with these contractual enhancements, however, is that absent statutory recognition it could not be guaranteed that they would be recognised or upheld by national courts, in particular when close-out netting is triggered by the insolvency of the counterparty. Indeed, it became questionable whether contractual enhancements of the set-off principle under the close-out netting technique were effective upon insolvency or whether they were to be considered as violating certain insolvency principles such as the principle of equality of unsecured creditors or the principle of cessation of business whereby all trading of assets and liabilities should cease under national insolvency law. The close-out netting provision was particularly vulnerable since notification would have to be given after the

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68 *Ibid*.

69 UNIDROIT 2011 Close-out Netting Report, 20; DALHUISEN (2019) Volume 3, 388.

70 These differences are also noted in the World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems where close-out netting is different from set-off 'because in one form it can consist of the setoff of non-money fungibles (such as securities or commodities deliverable on the same day, known as settlement netting) and because in its more important form it generally involves a cancellation by a counterparty of open contracts with the insolvent, followed by a setoff of losses and gains either way (closeout netting). So closeout netting is not just setoff.' WORLD BANK Principles (2001) 38.

opening of insolvency and hence may no longer have any legal effect on the insolvent counterparty.[71]

These lingering doubts led to statutory intervention in a number of jurisdictions in order to grant recognition to these contractual enhancements in insolvency. Thus, it has been seen that on the European Union level two Directives have been issued, namely the Settlement Finality Directive and the Financial Collateral Directive, which are designed *inter alia* to safeguard close-out netting provisions from the application of insolvency laws. As a prelude to considering the influence of the national set-off laws, if any, of the three selected jurisdictions upon the statutory recognition of close-out netting in Chapters 4 to 6, an overview of the historical origins of set-off in these jurisdictions is conducted in this part. This overview will also trace the philosophical thinking of the national legislators at the time when set-off was introduced in these jurisdictions. It will then be analysed in Chapter 8 whether the same philosophical traits also underpin the statutory recognition of close-out netting.

1.2.1 Historical Origins of Set-off

Set-off owes its origins to the Roman law concept of *compensatio*.[72] This concept was developed as part of Roman procedural law in the fourth through the second centuries B.C. in order to adapt the strict procedures involved in the enforcement of obligations to the exigencies of an expanding commercial society. This reform was initiated through the creation of a new magistracy, the *praetor*, in 367 B.C. who was vested with power to publish, in a yearly edict, new causes of action which would be recognised in his court.[73]

Two major problems existed at that time: first, Roman procedural law did not recognise the setting up of a counter-claim as a defence so that the Roman judge could either find for the plaintiff or completely absolve the defendant since lawsuits could only concentrate on one issue and, second, non-Roman citizens had no standing in front of Roman courts. In 243 B.C. the *praetor peregrinus* was appointed to hear cases in which non-citizens were parties. The former *praetor* became known as the *praetor urbanus*. The peregrine praetor decided cases on the basis of the *jus gentium*, *i.e.* the body of law regulating the commercial practice of non-citizen bankers and traders.[74] The peregrine praetor administered both the law and the procedure in his courts with flexibility. Thus, the practice grew that this praetor set out written instructions on the handling of the dispute to one of his *judices* in

71 DALHUISEN (2019) 394; VAN ZWIETEN (2018) 359.

72 For a detailed historical account of the influence of Roman Law on the legal systems of France, England and the US, see BURDICK (1938) 10 *et seq.*

73 TIGAR (1965) 226.

74 According to Burdick, the *jus gentium* developed on the basis of *ex bono et aequo* (right and fair). See BURDICK (1938) 4.

a so-called *formula*[75] which could also include the defendant's pleas to the plaintiff's allegations. It is assumed that one of the pleas allowed was the counterclaim, *i.e.* the *compensatio*. When the *formula* was imported into the urban praetor's court in 150 B.C., this procedure was probably adopted as well.

Early Roman law recognised two types of contract, contracts *stricti juris* and contracts *bonae fidei*. The former were unilateral binding promise type of contracts and the latter were bilateral contracts, the most important being the contract of sale – *emptio venditio*. The remedy for breach of this bilateral contract was the *judicium bonae fidei*, i.e. a good faith action, which entitled the defendant to raise an objection before the *judex* (and not necessarily already raised before the praetor or in the *formula*) that he should not be required to pay the full price of acquired goods, for example, because they were partly defective. This offset, demanded by the defendant as a matter of good faith and restricted to the same transaction, may be considered to mark the beginnings of *compensatio*.[76]

As Rome's financial demands increased in complexity, *compensatio* adapted to the new needs. Under Emperor Antonius Pius in the years 138 to 161 A.D. a private defendant could compensate claims against a government plaintiff provided that it was the same government department which was indebted to the plaintiff. Emperor Marcus Aurelius in the years 161 to 180 A.D. decreed that *compensatio* was available in *judiciis stricti juris*, *i.e.* in the action to enforce unilateral contracts, provided the defendant pleaded his claim by inserting an *exceptio doli* in the *formula*.[77] This meant that *compensatio* could be raised when the claims arose from different transactions and that, besides barring the plaintiff's action, judgment was given for the defendant by way of exception.

These rules were later codified under the *Code* of Justinian as follows:

> 'We order that *compensatio* takes place *ipso iure* in all actions, real or personal.
> §.1. We allow *compensatio* when the credit offered in payment is liquid, does not raise difficulties and is susceptible of being easily adjudicated; for it is unjust that when a case has been proven after much discussion, the other party, who is almost convicted, can plead *compensatio* against an ascertained and unmistakable debt, and defeat expectations by protracting the proceeding. Hence, we recommend that judges not lightly or with indifference admit *compensatio*, but proceed strictly; and should it appear that the proposed *compensatio* would require great and lengthy inquiry, we order that such a claim be saved for another action, and

75 The *formula* was a statement of the case by the praetor for the guidance of the *judex*.

76 TIGAR (1965) 229. According to Burdick, this was a 'natural and equitable adjudication of mutual claims' which was merely a recognition by the judge of what was being practised in business transactions. At these early times, however, *compensatio* was not yet a legal right but was allowed only at the discretion of the judge. See BURDICK (1938) 541.

77 This rule is reflected in Justinian's Institutiones 4.6.30. The *exceptio doli* could refer to a number of acts or omissions which may harm irrespective of the good or bad intention of the doer. LOYD (1916) 542.

> the former inquiry, almost entirely concluded, go to judgment. We except from the actions in which *compensatio* is available, the action of deposit …
> §.2. Neither may an adverse possessor set up *compensatio*.'[78]

A point of contention regards the meaning to be given to the words '*actiones ipso jure minuant*' in Justinian's Code. Thus, in case of two debts susceptible to compensation, it was questioned whether these were extinguished by mere operation of law or whether some further act was necessary, such as the judgment of the court or an agreement between the parties. According to Loyd, whilst commentators differ, the prevalent authority is not inclined to regard the Code as establishing the principle of automatic legal extinction of the original claim, although it is acknowledged that judicial compensation is to be regarded as retrospective to the time when the two claims first co-existed.[79]

Two main systems of law applied in France after the thirteenth century, namely customary law of each feudal fiefdom descended from the barbarian invaders, as influenced by Roman and canon law, and the written law in the south, based upon the compilations of Justinian. In the sixteenth century, although compensation was known to customary law, it was not allowed to be pursued. The main reason given for this approach is that lords refused to accept that claims are asserted in their jurisdiction by parties to a suit residing in a different fiefdom.[80] The monarch's encouragement to reduce customary law into writing in an attempt to introduce consistency and clarity in the law, led to the filling of gaps in the law mostly through reference to the compilations of Justinian. By the latter half of the sixteenth century a number of principalities allowed judicial offset.[81] Compensation, on the other hand, was treated with more caution since it was still considered as surrendering property at the order of a judge in a foreign forum. Thus, during these times compensation at most reduced a plaintiff's claim to zero.

In the south of France, the written law was based on Roman law and judges looked to Justinian for guidance. The sixteenth century saw the growth of a humanist school of jurisprudence. The humanists returned to Roman law to search, clarify and expound the thoughts of the Roman

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78 Code 4.31.14. See in this respect, BURDICK (1938) 543.

79 LOYD (1916) 543.

80 A different approach was taken under the customary law of La Marche which in 1521 incorporated the concept in its definition of judicial offset:

> 'Counterclaim takes place not at all, unless the parties be domiciliaries of the same forum, in which case it takes place without a new action.'

Coutumes generals de hut pay d come de la Marche § 101 (1521), in 4 N.C.G. 1101.

81 Thus, in 1580 Paris customary law provided that:

> 'A counterclaim in the secular court is not admissible unless it relates to the subject of the action, and the demand in counterclaim be a defence to the action first instituted; in this case the defendant, by means of his defence, may make himself plaintiff.'

Coutumes de la prevosté and vicomté de Paris § 106 (1580), in 3 N.C.G. 29.

lawmakers. Their interpretation of Justinian's words '*ipso iure*' were construed to mean 'by operation of law alone'.[82] This interpretation was adopted under the French written law where compensation of cross-demands took place automatically without the knowledge of the debtors at the moment the two debts first co-existed, and to the amount of the lesser debt. This notion was later transposed into the Napoleonic Code which integrated the customary and written law of France into one law. This provision was based on the premise that natural reason required that cross-demands be mutually extinguished.[83] This treatment of compensation spread to the countries which adopted the Napoleonic Code.

There was resistance in England to embrace this doctrine in view of the applicable formalistic procedure. The forms of action and the system of pleading were based on one issue, affirmed by one party and denied by the other. However, with the development of commerce, the significance of the bilateral obligation was understood as necessary for equitable treatment.[84] Set-off was first enacted into English law in the field of insolvency proceedings. The temporary insolvency act of 1705 provided that where there had been 'mutual credit' given between the insolvent and his debtor, the latter should not be compelled to pay more than the outstanding balance.[85]

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82 *Ibid.* 242.

83 The rule in the Napoleonic Code was mostly influenced by the work of the jurist Pothier who advocated a broad application of the automatic *compensatio*. According to Pothier, compensation is a payment and it is thus important that the two debts are in the same coin, fully due and liquidated. He held that the debt must be due between the same persons and in the same right. Pothier regarded compensation as automatic on the basis of the words '*ipso iure*' in Justinian's Code. *Ibid.* 246.

84 Thus, prior to any enactment on set-off, in 1676 Lord Guildford stated in the *Anonymous* case brought before the Court of Chancery under equitable jurisdiction:

> 'If there are accounts between two merchants, and one of them become bankrupt, the course is not to make the other, who perhaps upon stating the accounts is found indebted to the bankrupt, to pay the whole that originally was entrusted to him, and to put him for the recovery of what the bankrupt owes him, into the same condition with the rest of the creditors; but to make him pay that only which appears due to the bankrupt on the foot of the account; otherwise it will be for accounts betwixt them after the time of the other's becoming bankrupt, if any such were.'

Anonymous (1676) I Mod. 215, 86 ER 837. This was also the position taken by Lord Chief Justice Hale in *Chapman v. Darby*, 2 Vernon 117 (1689). According to Loyd, there is no doubt that equitable jurisdiction allowed set-off in cases of insolvency before any statutory provisions on the subject were enacted. See LOYD (1965) 547.

85 Act of 4 Anne, c. 17, sec. II (1705):

> 'And be it further enacted by the authority aforesaid, That where there shall appear to the commissioners, or the major part of them, that there hath been mutual credit given between such person or persons, against whom such commission shall issue forth, and any person or persons who shall be debtor or debtors to such person or persons, and due proof thereof made, and that the accounts are open and unbalanced, That then it shall be lawful for the commissioners in the said commission named, or the major part of them, or the assignee or assignees of such commission, to adjust the said account, and to take the balance due in full discharge thereof, and the person debtor to such bankrupt, shall not be compelled or obliged to pay more than shall appear to be due on such balance.'

Another temporary Act providing set-off relief was the Act of 1729[86] intended to reform debtors' prison sentences in insolvency proceedings of insolvent debtors

However, this Act is restricted to 'mutual debts' and hence it was doubted whether mutual debts of a different nature could be set off.[87] This was expressly resolved in the Act of 1735 which rendered the 1729 Act perpetual and which provided that mutual debts should be set-off 'notwithstanding that such debts are deemed in law to be of a different nature' and further that if either of the debts accrued by reason of a penalty in a bond, the amount to be included in the set-off was the amount 'truly and justly due'.[88] Set-off under the 1735 statute was only available where the debts were liquidated and recognised at law as distinct from in equity.[89] Neither case law nor statute provided that set-off operates automatically to extinguish mutually-owed claims. Set-off only permitted the defendant to put in his claim as of the time of the suit.[90]

Similar developments were taking place in the US. Mr Justice Story stated in the 1828 federal case *Greene v. Darling*:

> 'Since the statutes of set-off of mutual debts and credits, courts of equity have generally followed the course adopted in the construction of the statutes by courts of law; and have applied the doctrine to equitable debts; they have rarely, if ever, broken in upon the decisions at law, unless some other equity intervened, which justified them in granting relief beyond the rules of law, such as has been already alluded to. And, on the other hand, courts of law sometimes set off equitable against legal debts, as in Bottomley v. Brooke (I Term R. 619). The American courts have generally adopted the same principles, as far as the statutes of set off of the respective states have enabled them to act.'[91]

86 Act for the Relief of Debtors with respect to the Imprisonment of their Persons (1729) 2 Geo. II. Chap. 22, Sec. 13. These English Acts were adopted in substance in many US states and, even where not formally adopted into law, they influenced US legal opinion. See LOYD (1965) 551.

87 McCRACKEN (2010) 56.

88 An Act for the Relief of Debtors with respect to the Imprisonment of their Persons (1735) 8 Geo. II. Chap. 24, Sec. 5. DERHAM (2010) 12.

89 McCRACKEN (2010) 57. According to McCracken, the main thrust of this legislation was directed towards alleviating the poor conditions then prevailing in prisons, in particular to restrain the corrupt practices of the bailiffs and gaolers. However, by allowing an exercise of set-off Parliament was enabling a person to stay out of jail where, although in fact in debt, he was also owed a substantial amount by his creditor. The ability to strike a balance enabled him to show that in overall terms he was not a debtor. *Ibid.*

90 TIGAR (1965) 248.

91 (1828) 5 Mason 201.

Sepinuck notes that statutory recognition of set-off in the US predates the English statutes. Thus, as early as 1645 the colony of Virginia permitted civil defendants to set off debts owing by the plaintiff.[92] Maryland followed in 1654 with a system for discounting debts.[93] In 1682 it was the turn of Pennsylvania which also permitted a defendant to obtain affirmative relief if he remained a creditor after the set-off.[94] In 1714 New York adopted a statute similar to that of Pennsylvania but which required written notice to set off a debt to be given in the responsive plea.[95] Similar requirements were imposed in 1722 in New Jersey which further barred the creditor from bringing any action on his claim if it had not been raised in the responsive plea.[96] Sepinuck states that during these times set-off was restricted to contract and debt obligations.[97]

Commenting on the legal situation applicable in the nineteenth century, Loyd states as follows:

> '[…] there is a material difference between the then prevailing continental view of *compensation,* which of right extinguished the mutual debts, and set-off, which is a cross-demand within the control of the defendant to use if he pleases or to be preserved for a separate action. What seems probable is that the law on becoming conscious of a situation that offended common sense, or 'natural justice' as

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92 February 17, 1644-5, I Hening's Laws 294:

> 'Be it enacted by the authoritie of this present Grand Assembly for avoiding causes and suits at law, that where any suit shall be commenced in quarter court or county court, that if the defendant have either bill, bond or accompt of the plt. wherein he proves him debtor, that in such cases the courts do balance accs. consideration being had and allowance given to the plt. for his charges who first began his suit, as also to the time when such bills, bonds, accompts or demands were due to be compared with the accs. in balance, and this act to continue until the next assembly.'

This act was made perpetual at the session of 1646 (March, 1645-6, I Hening's Laws 314.

93 Act of Oct. 20, 1654, Chap. 23, I Md. Arch. (Asso.) 346:

> 'All lawful accompts produced and proved in court the defendant part shall hold play to the plfts. suit for debt. And shall be satisfactory to his demands, except the said account be above nine months' standing.'

94 Charter and Laws of Penna., 118:

> 'That for avoiding numerous suits, if two men dealing together, be indebted to each other, upon bonds, bills, bargains or the like, provided they be of equal clearness and truth, the defendant shall in his answer acknowledge the debt which the plaintiff demandeth, and defaulk what the plaintiff oweth to him upon like clearness.'

95 Act of 1714, Bradford's Laws (1726), p.93:

> 'Be it enacted, *etc.,* that is [any] two or more dealing together be indebted to each other upon bonds, bills, bargains, promises, accounts, or the like and one of them commence an action in any court of this [colony], if the defendant cannot gainsay the deed, bargain or assumption upon which he is sued it shall be lawful for such defendant, [giving note in writing, with the said pleas, of what he will insist upon at the trail for his discharge] and give any bond, bill, receipt account or bargain [so given notice of] in evidence, and if it shall [happen] that the defendant hath fully paid or satisfied the debt or sum demanded, the jury shall find for the defendant and judgment shall be entered that the plaintiff shall take nothing by his writ and shall pay the costs […]'

96 Laws of New Jersey (Ed. Of 1752), p. 98.

97 SEPINUCK (1988) 53.

> it was then called, with its usual baffling eclecticism, borrowed without credit from the foreign, and therefore presumptively outlandish, source the idea but not the form of the doctrine and adapted it empirically to its own needs.'[98]

It is evident that set-off, the predecessor of netting, has developed in different ways in France on one side and in England and the US on the other. Whilst French law was influenced by the regulation of *compensatio* under Roman law and included this concept as part of its codified law as a means of extinguishment of debts dictated by considerations of natural reason, Loyd notes that two distinct motives have shaped the development of set-off under English and US law, namely the idea that 'an injustice is done [to] the defendant in refusing him this privilege [and…] that unnecessary lawsuits are a nuisance'.[99] Generally speaking, it appears to be the case that the development of set-off in England and the US has been inspired by considerations of natural justice and also of efficacy of dealing with separate claims in one action. It will be seen in later chapters whether these motivations still surround the development of close-out netting during our times.

1.3 Preliminary Conclusions

This first chapter is intended to serve two purposes. The first is to provide an introductory understanding of the concept of close-out netting as it has evolved under the *lex mercatoria*. The sources of this type of *lex mercatoria* will be identified in Chapter 3. The second is to examine the relationship between close-out netting and set-off with a view to facilitating the analysis carried out at the end of this research on whether close-out netting is to be considered as a contractual enhancement of set-off and it is therefore expected that its recognition will have been influenced by national set-off rules.

Although the precise definition of netting may vary depending on its formulation in specific contracts, at its core netting is a contractual technique which serves to offset mutual obligations owed by two parties to a single net sum payable by one to the other. Viewed from this perspective, it is very similar to the concept of set-off. The flexibility with which netting has developed has led to various netting processes coming into existence, the more common being (i) settlement netting used in the process for the settlement of matured payment obligations owed reciprocally under financial contracts, (ii) novation netting whereby two or more contracts of the same type are terminated and replaced by a new contract that reflects only

98 LOYD (1916) 548. McCracken, however, states that the broader basis of set-off is purely procedural rather than as representing a substantive attempt to do justice between the parties. McCracken quotes the writings of Blackstone where set-off is regarded as procedural in nature and being designed to avoid circuity of action. See McCRACKEN (2010) 58.

99 LOYD (1916) 562.

the net balance of the terminated contracts and which is to be performed at a future date and (ii) close-out netting applied to early terminate outstanding obligations upon the occurrence of a trigger event leading to the calculation of one net amount due in respect of the terminated transactions. Although the precise specifications of close-out netting may vary depending on the nature of the transactions being closed out, in basic terms close-out netting comprises three elements, namely the occurrence of an event triggering the early termination of all outstanding transactions, the valuation of those transactions and the determination of one net amount. The diverse application of these three phases by the financial markets has been illustrated by an examination of the close-out netting provisions of two widely used master agreements, namely the 2002 ISDA master agreement and the 2011 GMRA.

It is at times considered that the netting concept has developed from the classic concept of set-off. The primary aim of set-off is the discharge of reciprocal obligations to the extent of the lesser obligation and may therefore be considered as a form of payment. At its inception, set-off, like netting, was a process created by the business community which was gradually recognised by the courts and subsequently incorporated into the written law. The origins of set-off date back to the second century B.C. to the Roman law concept of *compensatio* developed in the court of the peregrine praetor as a procedural measure similar to counterclaim in order to expedite commercial disputes. In the sixteenth century compensation was recognised by customary law and was first included in written law in the south of France following the sixteenth century where compensation of cross-demands took place automatically without the knowledge of the debtors from the moment the two debts first co-existed and to the amount of the lesser debt. This provision was based on the premise that natural reason required that cross-demands be mutually extinguished. This principle was incorporated into the Napoleonic Code from where it spread to other countries influenced by this Code. Although there was initial resistance to introduce this doctrine in England, it was gradually accepted in the early eighteenth century as an equitable means of resolving commercial disputes. It was initially restricted to mutual debts, though they could be different in nature, and was more in the nature of a cross-demand which the defendant could use to set-off against a claim made by its counterparty. This concept became generally accepted in England as an expression of natural justice. Similar developments also took place in the US where set-off was also initially considered as an innovative pleading tool based on equitable considerations.

The first sub-question to be considered in this research is whether close-out netting is a form of contractual enhancement of set-off, which gives rise to expectations that the national law on set-off might have influenced the recognition given to close-out netting, or whether it is a stand-alone concept. Whilst a more precise reply to this sub-question can only be given in relation to a particular national regime, certain preliminary observations can already be made on the basis of the conceptual analysis of the constitutive elements of close-out netting made in this chapter.

First, in relation to their constitutive steps, it may be remarked that the first step of close-out netting, namely the termination step, is not present in set-off. This is arguably the most distinctive element of close-out netting which extends its scope of application beyond that of a means of payment such as set-off. Termination can take various forms. Thus, it has been seen that the 2002 ISDA master agreement provides for the extinguishment of derivative obligations and the calculation of a replacement value, whilst the 2011 GMRA relies on the acceleration of the maturities of all transactions under repurchase agreements so that the parties' obligations are due immediately. Termination allows parties to a bilateral relationship to crystallise their exposures with the defaulting counterparty and is perhaps the step which most renders close-out netting suitable as a risk mitigation tool.

The second step relates to the valuation of the terminated obligations. In this respect, it will be considered in the national law chapters that national law may impose requirements for the validity of set-off. For instance, set-off may be limited to matured payment (as opposed to delivery) obligations of the same kind arising under the same agreement. When considered from the point of view of this second step, it may be said that the close-out netting technique developed as a contractual enhancement intended to overcome these statutory restrictions of set-off. This is because although mutuality of obligations may still be considered a requirement for netting, however certain restrictions imposed on set-off do not also burden close-out netting. Thus, it is not required that the obligations covered by a close-out netting provision arise out of the same contract or legal relationship, or even be of the same kind. Netting may extend to monetary and delivery obligations, and even to obligations expressed in different currencies In consideration of this step alone, it may be considered that close-out netting borrowed from set-off and overcame the restrictions in valuation attached to set-off. This has not only rendered valuation more flexible but has widened the scope of close-out netting to such an extent that it may be dubious whether the flexibility can be justified under the equitable considerations or the procedural efficacy benefits which could have justified the development of set-off in the early times.

As regards the third step, there is no particular form which the determination of a close-out amount should take. Indeed, set-off is one form among others which could lead to the determination of a close-out amount. It has been seen that whilst the 2002 ISDA master agreement applies what may be termed a modified type of novation which establishes the replacement value of the terminated transactions, the 2011 GMRA resorts to set-off to achieve a single payment amount. However, the possible use of set-off as a modality to determine a close-out amount does not impinge upon the relationship between close-out netting and set-off since set-off in this third phase of close-out netting is resorted to as an optional (contractual) mechanism of achieving a single amount when this form is suitable to the particular circumstances of the case.

These observations give rise to a number of preliminary conclusions which will necessarily vary depending on the applicable national law. Thus, it appears that the link between close-out netting and set-off is not as intrinsic as it is sometimes declared to be by international associations or in academic writings. The all-important termination phase on the basis of which close-out netting can be exercised is not a constitutive element of set-off. This brings an element of certainty in close-out netting which is determined contractually by the parties whilst in set-off parties have either to rely on the interpretation of the law to ascertain when set-off may be exercised or, even more cumbersome, they may have to raise a plea in court to enforce their set-off rights. The second and third steps of close-out netting are, to some extent, shared with set-off but these steps are also shared, in varying degrees, with other concepts or mechanisms such as that of the account current and novation which also require mutuality and involve an element of calculation and determination of a single amount.

Such observations may, from a conceptual point of view, lead to the conclusion that close-out netting is a stand-alone concept which was developed by the market as a remedy against the suffering of losses caused by an event of default and hence as a risk mitigation mechanism. It is also a highly flexible mechanism which may be adapted in form to suit the circumstances of the market it applies to, even though in substance it remains composed of the three constitutive steps identified in this chapter. It does not seem that considerations of justice or fairness or procedural efficacy formed the basis giving rise to close-out netting. It may be argued that in these circumstances the national law restrictions which apply to set-off should not influence the recognition granted by legislators to close-out netting provisions. It will be seen in Part II of this research whether this is the case in relation to the law of the three selected jurisdictions.

2 Introduction to Insolvency and Close-out Netting

2.1 Close-out Netting and its Treatment under Insolvency Law

Whilst the enforceability of close-out netting provisions on the basis of the principle of contractual freedom may be relatively unproblematic when enforced against a solvent defaulting party, the situation may be different if the defaulting party is insolvent.[1] Insolvency law is, to a considerable extent, mandatory law reflecting public policy.[2] Insolvency law plays an important role in the organisation of the affairs of a failing business. In its basic form, insolvency law provides for collective and compulsory proceedings on behalf of an insolvent debtor's creditors (most importantly its unsecured creditors), under which each creditor's individual rights and remedies for collection and enforcement are replaced by a procedure that applies for the benefit of the whole body of creditors and establishes a priority system, resulting in either the liquidation and distribution of the debtor's assets among its creditors or the reorganisation of the debtor's affairs, achieved through a rearrangement of its affairs with its creditors.[3]

It is arguably the case that the enforcement of close-out netting provisions will in most jurisdictions clash with some of the fundamental rules of insolvency law which traditionally seek to preserve the assets of the insolvent party for the benefit of its stakeholders.[4] These rules include, amongst others, the equal treatment of equally ranked creditors (the so-called '*pari passu* principle'), the coordinated management and enhancement of the insolvency estate and the preservation of assets of the insolvent estate in the interests of creditors.[5] In a number of jurisdictions this has led to the adoption of derogations or carve-outs from the provisions of national insolvency laws to ensure the enforceability of close-out netting arrangements 'in

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1 UNIDROIT 2011 Close-out Netting Report, 14. For a discussion on the different groupings of national insolvency regimes, see WESSELS (2012) 383.

2 In this respect Wessels states that provisions of insolvency or bankruptcy law cannot usually be set aside by means of a choice of law provision in a netting agreement. See WESSELS (1997) 189.

3 In addition to these two goals of insolvency law (*i.e.* distribution and reorganisation), some academic writers indicate a third goal which relates to the provision of a mechanism by which the causes of failure can be identified and those guilty of mismanagement brought to justice. See VAN ZWIETEN (2018) 74; FINCH & MILMAN (2017) 15.

4 This will especially be the case in insolvency liquidations since in restructuring the basis for negotiating will be formed by principles of contract law.

5 See McKNIGHT (1996, updatable), para 38; PEETERS (2014) 66.

accordance with their terms' as governed by the *lex contractus* in the event of the insolvency of one of the parties.

It is the scope of this chapter to focus on the relationship between close-out netting and the application of national insolvency law, including bank resolution measures. This is intended to provide a theoretical background to the issues which will be taken into consideration in Parts II and III of this research where answers will be provided to the second and third sub-questions referred to in the Introduction, namely on the possible influence exerted by national insolvency and bank resolution laws on the recognition given to close-out netting provisions under the laws of the three selected jurisdictions. This is achieved by first giving an overview of some derogations granted to protect close-out netting provisions from the application of national insolvency law. This overview will be based on the UNIDROIT Principles which is considered a landmark document in the development of the close-out netting mechanism. This is followed by an analysis of the resurgence of bank resolution laws which, as will be seen in the national law chapters, have introduced restrictions in the freedom of the parties to apply their close-out netting provisions.

2.1.1 Derogations from Insolvency Law Principles

Wessels mentions a number of insolvency law principles which commonly feature in national insolvency law regimes.[6] A number of these principles which require a carve-out for close-out netting provisions to be effective are indicated in this chapter. The first derogation relates to the prohibition of termination of transactions and of pursuing individual creditor claims, known as the 'stay'. The stay is designed to control the loss of value of the insolvent estate by stopping the dismantling of the insolvent estate through private creditor action and the creation of new claims in order to rescue the business or otherwise to liquidate it.[7] Principle 7(1)(a) of the UNIDROIT Principles provides that 'the law of the implementing State should ensure that upon the commencement of an insolvency proceeding or in the context of a resolution regime in relation to a party to a close-out netting provision: (a) the operation of the close-out netting provision is not stayed'. The scope of this derogation is to ensure that in the exercise of early termination of a financial contract, a netting creditor is not fettered by the 'stay' or other

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6 WESSELS (2012) 385.

7 In terms of the World Bank Principles for Effective Creditor Rights and Insolvency Systems, the rationale for the stay is that attempts at rescuing a business may fail unless the essential assets and component parts of the property of the debtor and its businesses are maintained. This policy supporting rescue necessitates that an injunction or stay of creditor actions be imposed for a reasonable period to prevent creditors from disassembling the business while the parties negotiate a rescue plan. On the other hand, in case of liquidation the stay aims to maximise the value of the debtor's estate so that creditors can be paid from the proceeds of the sale of the debtor's assets. See WORLD BANK Principles (2001), para 136 & 137.

national law restriction on termination rights that may automatically result from the commencement of insolvency proceedings or be imposed by the insolvency administrator or the insolvency court.[8]

Second, the stay may in certain jurisdictions also be intended to give the opportunity to the insolvency administrator to repudiate unfavourable contracts and to insist on performance of favourable contracts for the benefit of the insolvent estate. This is normally referred to as 'cherry-picking' whereby the insolvency administrator may decide to continue any transaction which is favourable for the insolvent party, whilst repudiating any unfavourable transactions, thus enabling the insolvency administrator to ensure the fullest possible preservation of the value of the insolvent estate. In relation to 'cherry-picking' powers, Principle 7(1)(b) of the UNIDROIT Principles provides that:

> 'the insolvency administrator, court or resolution authority should not be allowed to demand from the other party performance of any of the obligations covered by the close-out netting provision while rejecting the performance of any obligation owed to the other party that is covered by the close-out netting provision.'

Without an exemption from the exercise of such powers, the netting creditor would be faced with the 'unbundling' of the various obligations concluded under a single netting agreement and the impossibility to determine a global close-out netting amount.[9]

The third derogation is from avoidance provisions. Principle 7(1)(c) and (d) of the UNIDROIT Principles provide that:

> 'the mere entering into and operation of the close-out netting provision as such should not constitute grounds for the avoidance of the close-out netting provision on the basis that it is deemed inconsistent with the principle of equal treatment of creditors',

and

> 'the operation of the close-out netting provision, and the inclusion of any obligation in the calculation of the single net obligation under the close-out netting provision, should not be restricted merely because the close-out netting provision was entered into, an obligation covered by the provision arose or the single net obligation under the close-out netting provision became due and payable during a prescribed period before, or on the day of but before, the commencement of the proceeding.'

8 UNIDROIT 2013 Close-out Netting Principles, Principle 7(1)(a), 46.

9 PEETERS (2014) 68. The case may arise that one or some of the obligations or contracts covered by the close-out netting provision may, for any reason at law, be invalid or unenforceable. According to the UNIDROIT Principles the solution in this case is for the invalid obligation or contract to be severed from the rest of the bundle to ensure that it does not affect the validity of the other obligations or contracts. See UNIDROIT 2013 Close-out Netting Principles, 55.

Acts of the netting creditor are typically exempted from any power of the insolvency administrator or the insolvency court which may exist under national law to set aside or avoid payments or other transfers that have been made during a co-called 'suspect period', which is a period either fixed by statute or otherwise defined, for instance, by the insolvency court prior to insolvency usually on the basis that this would give an unjustified preference to some creditors over others or give rise to unjustified deprivation of the insolvency estate of relevant assets.[10] The same applies to any 'zero-hour rules', namely rules that bring forward the commencement of insolvency proceedings to 0:00 hours of the day of the decision to open insolvency proceedings.[11] In this regard, the carve-out would ensure that the enforceability of the close-out netting provision would not be impaired by the application of the zero-hour rule. These avoidance powers would otherwise frustrate the possibility of affecting early termination under a close-out netting provision, in particular since it is the commencement of the insolvency proceedings itself that triggers the close-out netting mechanism.

These three derogations or carve-outs (*i.e.* the stay, cherry-picking and avoidance) should not continue to safeguard the enforceability of close-out netting provisions where there is fraudulent intent. This is reiterated in Principle 7(2) of the UNIDROIT Principles which provides that the proposed carve-outs from the rules of insolvency law should:

> 'not affect a partial or total restriction of the operation of a close-out netting provision under the insolvency law of the implementing State on grounds which include factors […] such as the knowledge of a pending insolvency proceeding at the time the close-out netting provision was entered into or the obligation arose, the ranking of categories of claims, or the avoidance of a transaction as a fraud of creditors.'[12]

10 *Ibid.* 69. According to the World Bank's Principles on Effective Creditor Rights and Insolvency Systems, transfers covered by the avoidance principles normally fall into two categories: fraudulent and preferential. Fraudulent transfers are those made in collusion with the debtor with an intent to defraud creditors, while preferences are typically payments made in the usual course of affairs but which violate the *pari passu* principle by preferring some creditors over others who may remain unpaid during the period of insolvency leading up to the filing of insolvency. See WORLD BANK Principles (2001), para 126. In those jurisdictions where action taken upon insolvency is regarded as suspicious or may be impugned, parties to a close-out netting agreement have devised the concept of automatic early termination in terms of which all transactions are deemed to have been automatically terminated and netted or set off immediately prior to the occurrence of the relevant insolvency event, with the intention that they are taken outside of the restrictions related to the moment of insolvency. Annetts and Murray are of the opinion that this technique of automatic early termination is to be used only where necessary. They opine that purely contractual solutions of this kind to insolvency law problems are of dubious efficacy in the face of public policy arguments. See ANNETTS & MURRAY (2012) 281.

11 UNIDROIT 2013 Close-out Netting Principles, 61.

12 *Ibid.* 47.

The aforementioned derogations effectively result in the non-enforceability of the *pari passu* principle in relation to the exercise of close-out netting rights. Under this principle all unsecured creditors share proportionally in the assets of the insolvent estate that are available for residual distribution, meaning that these creditors are paid *pro rata* to the extent of their pre-insolvency claims and, depending on national law, in conformity with the class of claims to which they belong. The *pari passu* principle applies only to the unencumbered assets of the insolvent estate that are available for distribution. Thus, where the insolvent debtor has given security rights over its assets, these assets are available for distribution only to the extent that the value of those assets exceeds the amount of the secured credit.[13]

Prior to insolvency creditors are free to pursue whatever enforcement measures are available to them, subject to any applicable *moratoria* or cooling off periods. As a general rule, insolvency puts an end to this private individual action to enable the appointed insolvency administrator or practitioner to pursue the orderly administration of the insolvent estate and the liquidation of the assets, and to distribute *pari passu* the net proceeds derived from the sale of assets of the insolvent estate. The rationale of the *pari passu* principle is that within a mandatory, collective regime it facilitates a transparent and orderly procedure of dealing with unsecured creditor claims. The *pari passu* principle is also said to bring a measure of fairness in the insolvency proceedings since it aims to ensure equality of treatment between unsecured creditors. Its effect is to invalidate agreements, payments and transfers which could give unfair preference to a particular creditor by removal from the insolvent estate of an asset that would otherwise have been available for the general body of creditors.[14]

In cases where national insolvency law allows prior private arrangements such as close-out netting provisions to be enforceable upon insolvency, such arrangements are enforced against the insolvent debtor thus bypassing the *pari passu* principle. The effect of insolvency close-out netting is that upon the occurrence of insolvency the parties reduce their mutual obligations to one single balance of indebtedness. This implies that the netting creditor may apply what is due by the insolvent debtor from its own dues, thus ensuring payment of its claim *pro tanto* ahead of other creditors. One policy justification for allowing close-out netting is that each party engaged in mutual dealings extended credit in reliance on the ability to enforce the close-out provision. Nonetheless, jurisdictions may impose limitations on the extent to which private arrangements can supersede the

13 FINCH & MILMAN (2017) 511.

14 VAN ZWIETEN (2018) 304. Writing in the context of English law, van Zwieten clarifies that, unlike the provisions on preferences that are intended to unwind payments and transfers already made to a creditor on the eve of the opening of insolvency proceedings, the *pari passu* rule does not have retroactive effect. But it could lead to the annulment of agreements designed to give one creditor a benefit at the expense of the others upon insolvency. *Ibid.*

application of the *pari passu* principle.[15] A typical example relates to the creditor's knowledge of the impending insolvency of the debtor at the time of entering into the close-out netting agreement.[16]

2.2 Credit Institutions, Resolution Measures and Financial Stability

The insolvency and resolution of credit institutions are in some jurisdictions subject to general insolvency laws whereby ordinary insolvency principles generally apply to credit institutions, while in other jurisdictions credit institutions are subject to special insolvency regimes administered by competent administrative authorities.[17] In terms of the World Bank 2001 Principles and Guidelines for Effective Insolvency and Creditors Rights Systems credit institutions are different from other market participants because a safe and sound banking system is indispensable for sustainable economic growth. Moreover, credit institutions are vulnerable to destructive panics caused by a sudden loss of public confidence which would lead to so-called 'bank runs' whereby depositors rush to withdraw their deposits from a distressed credit institution.[18] Another reason given by the World Bank for the special treatment of credit institutions is related to the interconnectedness of these institutions with other domestic and international financial institutions whereby the inability of one sufficiently interconnected credit institution to honour its obligations could affect the health of other financial institutions resulting in a systemic crisis both within and across borders.[19] It is therefore considered to be necessary that the prudential regulation and resolution of credit institutions are driven by financial stability considerations.[20]

It has been stated that this shift in the purpose of insolvency law in relation to credit institutions puts pressure on the relationship between bank insolvency law and general insolvency law. For instance, normal insolvency law remains directed at liquidation of the insolvent business and the maxi-

15 PAECH (2014) 440.

16 This is for instance the case under Article 8(2) of the EU Financial Collateral Directive.

17 LASTRA (2015) 165. For an overview of the shortcomings of general insolvency proceedings in relation to bank failures, see Stephan Madaus, 'Bank Failure and Pre-Emptive Planning', in HAENTJENS & WESSELS (2014) 52.

18 WORLD BANK Principles (2001), Annex I, para 2. According to the World Bank, this loss of confidence in financial soundness mainly stems from the traditional role of credit institutions in intermediating between short-term demand deposits and medium- and long-term loans with the result that a distressed credit institution may not be able to meet demands for deposit withdrawals, thereby becoming illiquid. *Ibid.* para 4.

19 *Ibid.*

20 In a 2009 report which updates the concerns expressed in the World Bank 2001 report in relation to the failure of banks, the IMF and the World Bank sum up these financial stability considerations to refer to the smooth functioning of payment and settlement systems, the protection of the depositing public, and the preservation of the credit intermediation function. See IMF and World Bank 2009 Bank Insolvency Report, 16.

misation of credit value, whereas bank insolvency law is directed at both the preservation of certain assets and functions, such as insured deposits and critical services, and the controlled liquidation of all other assets of the credit institution.[21]

One notable difference between the two regimes is that the restructuring or resolution of credit institutions is a broader concept than rehabilitation under general insolvency law, both in terms of function and timeliness.[22] Corporate rehabilitation under general insolvency law typically commences only if the corporate debtor is declared insolvent in statutory terms. By contrast, the restructuring of credit institutions is usually a consequence of the regulatory enforcement of prudential supervision which may be exercised when a credit institution fails to meet statutory solvency levels. Bank restructuring may thus begin at an earlier stage than corporate rehabilitation.[23] As will be seen in more detail in the national law chapters, the special treatment of bank restructuring has important consequences for the legal rights of creditors (and, it may be added, its shareholders). In general insolvency proceedings, such rights are protected, and at times even preferred, by procedural safeguards and by judicial administration of rehabilitation and liquidation proceedings. However, fewer or different safeguards may be available in bank restructuring which is typically under the control of an administrative authority subject to principles of administrative law intended primarily to allow for more timely solutions. In its report on the Resolution of Cross-Border Banks, the IMF expresses the situation as follows:

21 HAENTJENS (2014a) 72. Haentjens notes two consequences of this pressure in the relationship between general insolvency law and bank resolution law. From a theoretical perspective, it may endanger the coherence of relevant national systems of law which can thus affect the efficiency, transparency and rationality of a legal system. Thus, any incoherence between bank resolution rules and insolvency law may undermine the equality, legal certainty and rationality of a legal system. From a practical perspective, as a matter of legal interpretation, bank resolution rules will be deemed to be embedded in the general insolvency regime and hence the latter regime will remain applicable in the case of a *lacuna* in the specific bank resolution rules. *Ibid.* 73.

22 To this may be added that on account of the serious consequences of bank failure, there is a bias in favour of saving failing banks. This may also be due to the fact that states place a high value on the uninterrupted operations of credit institutions and accessibility of depositors' savings. Thus, there is typically active participation by a state or state authorities in the restructuring of insolvent banks in situations where their financial and operational condition might, under general insolvency principles, point to their closure and liquidation. This is particularly the case in relation to large banks which are deemed 'too big to fail'. See MAYES & LIUKSILA (2004) 281.

23 WORLD BANK Principles (2001), Annex I, para 8, p 64. According to Lastra, the term 'resolution' has become a term of art in the aftermath of the financial crisis. Lastra states that bank resolution is at the end of the spectrum of the supervisory process when there is already crisis management but before actual insolvency. Resolution is therefore considered as part of the 'pre-insolvency phase' for failing credit institutions though there are instances where resolution also encompasses actual insolvency. See LASTRA (2015) 166.

> 'Resolution powers overrule ordinary private property and contractual rights in the interests of wider public interests such as financial stability. Accordingly, countries which adopt such resolution powers need to have strong safeguard mechanisms which ensure that powers are exercised appropriately. The effectiveness of international resolution action depends on all the involved countries having minimum safeguard protections that would be available to all creditors of the affected entity irrespective of nationality. These safeguards would *inter alia* ensure that […] netting and financial collateral arrangements are respected (subject potentially to the temporary suspension of close out netting rights in respect of financial contracts transferred to a solvent third party) […]'[24]

Credit institutions and certain investment firms have been singled out for special treatment in case of failure or pending failure. This has implied, *inter alia*, that the exercise of contractual termination rights has been affected by a temporary stay, though all safeguards should normally remain in place. Such resolution regimes have been put in place in some jurisdictions in recognition of the fact that financial stability considerations should be given due precedence over party autonomy relating to the exercise of termination rights. The question arises whether future developments will extend the category of institutions which will be similarly regulated in case of distress and whether the restrictions on party autonomy will extend beyond the temporary stay on termination rights that is currently being implemented in a number of jurisdictions. This will bring the relationship between contractual close-out netting rights and insolvency laws in the financial markets under more scrutiny and may lead to further re-consideration of the recognition granted to close-out netting provisions in the face of a pending failure of a market participant.

2.3 Preliminary Conclusions

It is the aim of this chapter to provide a preliminary understanding of the type of issues or obstacles that may be encountered by counterparties in the recognition given to their close-out netting provisions in the light of their national insolvency and bank resolution regimes. For this reason, the recognition of close-out netting provisions requires in most jurisdictions statutory intervention to ensure that parties can rely on their contractual rights and it is to be expected that the type of derogations granted, or the restrictions introduced, by legislators in view of their insolvency and bank resolution regimes may vary from one jurisdiction to another.

It has been seen that, from a conceptual point of view, the recognition of a close-out netting provision requires a number of important derogations or carve-outs from national insolvency law principles. The UNIDROIT Principles make a number of proposals related to the recognition of close-out

24 IMF 2010 Resolution of Cross-Border Banks, Box 7 at 22.

netting provisions which ensure that (i) the operation of close-out netting provisions are not stayed upon the commencement of an insolvency or resolution proceeding, (ii) the court or insolvency practitioner is not allowed to exercise cherry-picking powers in relation to obligations covered by a close-out netting provision, and (iii) the operation of a close-out netting provision during a suspect period does not constitute a ground for avoidance on the basis that it is deemed detrimental to the equal treatment of creditors. The enforceability of insolvency close-out netting is considered an important derogation from the *pari passu* principle as it directly affects the amount of assets of the insolvent estate which are available for liquidation and proportional distribution among unsecured creditors.

A lesson learnt from the recent financial crisis is that the private termination of contractual obligations may prevent regulatory authorities from taking resolution measures to resolve the financial difficulties faced by a systemically important market participant. For this reason, it will be seen in the next chapter that post-crisis statements issued by international entities such as the BIS and the FSB recommend the introduction of legislative powers allowing national authorities to delay the private exercise of termination rights in order to permit the transfer of financial contracts of an institution under resolution to a solvent institution.

This realisation triggers the question of when the private right of closing out should give way to the public policy objectives sought to be achieved by national insolvency law. From a traditional perspective, national insolvency law seeks to lay down rules to protect the value of the insolvent estate to ensure maximisation of assets for distribution among the insolvent debtor's creditors. With the surging importance of financial stability as a goal to be pursued by the State, there is nowadays a trend for insolvency regulation of certain financial market participants, such as credit institutions or investment firms which are either too highly interconnected or which perform critical services in society, to take into consideration new interests such as the general interest of the public or postulate a different way of looking at systemic risk. This has resulted in a reconsideration of the extent of recognition hitherto granted to close-out netting provisions with the result that we now see the introduction of limited restrictions, such as the imposition of a temporary stay, on the exercise of private termination rights to allow for the orderly resolution of these entities. The influences of the national insolvency law and the national bank resolution regime on the development of close-out netting will be viewed in Part II in the light of English, French and US laws.

3 Introduction to *Lex Mercatoria* and Close-out Netting

3.1 *Lex Mercatoria* and the Development of Close-out Netting

It is generally an undisputed fact that close-out netting first developed as a market tool under the *lex mercatoria* and was eventually granted recognition by national legislators to provide legal certainty to netting counterparties that they can rely on their contractual netting rights. It is the scope of this chapter to consider the sources of the *lex mercatoria* as defined in the Introduction which are deemed to have led to the development of close-out netting and to have influenced this global statutory recognition of close-out netting provisions. The chapter will commence with an overview of the statements issued by public and private international bodies in relation to the recognition of close-out netting before the financial crisis of 2008-2009. These sources provided the necessary impetus globally for national legislators to grant statutory recognition to close-out netting provisions 'in accordance with their terms'. In the second part note will be taken of the restrictions and safeguards to the exercise of close-out netting rights advocated by public bodies in the wake of the financial crisis in order not to hamper the effectiveness of resolution measures. These sources were influential in retracting, in part, the recognition given by national legislators to close-out netting on the basis of contractual freedom due to financial stability considerations. In the third part, an analysis is made of the regulation of close-out netting under EU law, also considered to be a source of special *lex mercatoria* given that this law influenced not only the netting laws of EU Member States but possibly also beyond as will be seen in Part III of this research. The manner in which these sources of *lex mercatoria* may have influenced the development of the netting laws of England, France and the US will be considered in Chapter 8.

3.2 The Development of Close-out Netting by the Financial Markets

This part reviews a number of international developments which paved the way for the global statutory recognition of close-out netting. In addition to enumerating the sources of *lex mercatoria* relating to the development of close-out netting, the aim of this overview is twofold. First, it provides a historical understanding of how supranational bodies and the industry perceived the usefulness of close-out netting in averting risks facing financial institutions, in particular in the derivatives markets. Second, it manifests the change in attitude of international regulatory bodies before and after the financial crisis towards the effect of close-out netting provisions on systemic risk. This change in approach served to further shape the development of close-out netting in the market. It is proposed to start with the declarations made by public international bodies, followed by the documents and instruments issued by private market associations.

3.2.1 Early International Reports on the Netting Process

Arguably, the first formal international recognition of the close-out netting mechanism was made in the Angell Report on Netting Schemes prepared in February 1989 by the Group of Experts on Payment Systems of the central banks of the Group of Ten countries under the auspices of the BIS. The study is based on an analysis of various netting arrangements entered into by banks in relation to financial netting schemes for foreign exchange contracts and payment transfers. The report concludes that based on the assumption that close-out netting provisions are enforceable, arrangements which net outstanding financial or payment obligations reduce liquidity risk and also systemic risk since the netting calculation allows settlement payments due from a counterparty to be used to settle payments due to the counterparty, but it leaves counterparty credit risk unchanged since the gross obligations underlying the netted amount are not extinguished or may even induce risk if net exposures are treated as if they were 'true exposures'.[1]

The Angell Report was followed by the Lamfalussy Report prepared by the Committee on Payments and Settlement Systems of the BIS in November 1990. This report considers the advantages of netting in terms of improving the efficiency and stability of interbank settlements by reducing costs and risks and considers that the effective reductions in exposures depend on the legal soundness of netting arrangements. Otherwise, the report states, uncertainty as to the legal soundness of a netting scheme will serve to exacerbate systemic risk as it obscures the level of exposures.[2]

The Lamfalussy Report constituted a point of reference in a number of other important reports or recommendations made by international organisations. Thus, the Giovannini Group which was set up by the European Commission Directorate-General for Economic and Financial Affairs to report on barriers in the EU leading to fragmentation in the cross-border clearing and settlement arrangements indicated in its November 2001 report that one important barrier relates to the national differences in the legal treatment of bilateral netting for financial transactions. This Giovannini Report notes that the principle that mutual obligations arising in financial

1 See BIS 1989 Angell Report, 6 & 14. It is important to note that the Angell Report was written at a time when legal regimes on the finality and irrevocability of payment transfers were not yet in force and as a result it was still fairly possible to unwind transfer orders and netting instructions, especially upon insolvency of a participant.

2 BIS 1990 Lamfalussy Report, 7.

market transactions may be netted has been accepted throughout the EU. It further notes that this arises in some countries as a natural feature of their legal system (as it is the case in Germany and the UK) and in others by virtue of specific legislation passed for the purpose (as it is the case in Spain and France). According to the report, where netting has been introduced by such legislation, its availability is normally limited to specific products, types of counterparty or forms of contractual documentation. This leads to the need for detailed analysis of the relevant features of a transaction before it can be safely assumed that netting is available. The report therefore advocates the removal of all remaining legal uncertainties as to netting, especially if multilateral netting schemes are to be established in the context of clearing systems.[3]

At the same time when the Giovannini Report was published in the EU, the World Bank issued its 2001 Principles for Effective Creditor Rights and Insolvency Systems designed as a broad-assessment tool to assist countries in their efforts to evaluate and improve the core aspects of their commercial law systems required for a sound investment climate and commerce. In its Principle 14 on treatment of contractual obligations, it is recommended that the law should allow for interference with contractual obligations that are not fully performed to the extent necessary to achieve the objectives of the insolvency process, whether to enforce, cancel or assign contracts, except where there is a compelling commercial, public or social interest in upholding the contractual rights of the counterparty to the contract. In its explanatory text on Principle 14, the World Bank recommends the enactment of carve-outs for financial and derivative contracts from national insolvency laws mainly due to the fact that use is made of derivative contracts in risk hedging of international transactions that demands the highest level of certainty for the international community.[4]

In 2004 UNCITRAL adopted a Legislative Guide on Insolvency Law which refers to the enforceability of close-out netting as a feature to be considered when designing corporate insolvency law and advises that close-out netting should be permitted under the applicable insolvency procedure in relation to transactions covered by financial contracts regardless of whether the termination of the contracts occurs prior to or after the commencement of insolvency proceedings.[5] The reason given is that financial transactions on financial markets reduce the potential for systemic risk that could threaten the stability of financial markets by providing certainty with respect to the rights of parties to a financial contract when one party fails to perform for reasons of insolvency. The UNCITRAL Legislative

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3 EUROPEAN COMMISSION 2001 Giovannini Group First Report, 57. In a second report of the Giovannini Group, it was indicated that the EU Financial Collateral Directive removes much of the uncertainty indicated in the first Giovannini report. See EUROPEAN COMMISSION 2003 Giovannini Group Second Report, 12.

4 WORLD BANK Principles (2001), para 125 p 38.

5 UNCITRAL Legislative Guide (2004), Recommendations 7(g) & 101-107.

Guide also sets a conflict of laws rule and provides that the effects of insolvency proceedings on the rights and obligations of parties in, *inter alia*, a regulated financial market are to be governed solely by the law applicable to that market.[6]

In 2005 the World Bank coordinated the work of the UNCITRAL Legislative Guide with its own 2001 Principles to formulate a set of standards on insolvency and creditor rights[7] and published a document setting out a unified insolvency and creditor rights standard (ICR Standard) integrating the principles under both documents. The Expert Working Group of the Insolvency Creditor/Debtor Regimes Task Force of the World Bank proposed the following Standard C10.4:

> 'C10.4 Exceptions to the general rule of contract treatment in insolvency proceedings should be limited, clearly defined, and allowed only for compelling commercial, public, or social interests, such as in the following cases: […] upholding (subject to a possible short stay for a defined period) termination, netting, and close-out provisions contained in clearly defined types of financial contracts, where undue delay of such actions would, because of the type of counterparty or transaction, create risks to financial market stability […].'

In paragraph (5) of the minutes of the meeting of the Expert Group of 17 December 2014, the rationale given for this amendment is that whilst it is acknowledged that legal certainty and enforceability of contracts in accordance with their terms is critical to economic activity, it was also acknowledged that:

> '[C]ertainty alone cannot be a justification for immunizing certain types of contracts from the application of fundamental principles of insolvency law. The current international norms seek to offer a framework for providing legal certainty while recognizing the need for collective action mechanisms to allow for orderly enforcement and to ensure financial market stability.'

This appears to be a prelude to the approach taken to the treatment of close-out netting and other contractual termination provisions after the financial crisis.

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6 *Ibid.*, Recommendation 32. Wessels notes in relation to this recommendation that a balance has to be maintained between the goals pursued by the *lex concursus* and the validity and effectiveness of rights under the law of the forum. In relation to this rule, a balance is maintained between (i) the social policy considerations reflected in the commercial certainty and risk reduction for the parties, (ii) the reasonableness of permitting reliance by the parties on the law creating the rights and (iii) the necessity of protecting confidence in the system and avoiding systemic risk. He considers that the last consideration favours the protection of a country's financial stability whereas the first two are more concerned with individual interests. See WESSELS (2015), para 10419.

7 WORLD BANK Report (2005), Standard C10.1–C10.4, p 32.

3.2.2 Netting in the Aftermath of the Financial Crisis

In the aftermath of the financial crisis of 2008-2009, international regulatory fora worked on the mechanisms that would allow failing financial institutions to be resolved (without resorting to State sponsored bail-outs) while preserving financial stability.[8] At a global level, the BCBS of the BIS and the FSB formulated resolution principles, some of which are directly relevant to close-out netting. Thus, in its 2010 Report and Recommendations of the Cross-border Bank Resolution Group,[9] the BCBS notes that enforceable netting agreements serve to reduce systemic risk and enhance the resiliency of critical financial or market functions. It thus provides in Recommendation 8 of the Report that '[n]ational authorities should promote the convergence of national rules governing the enforceability of close-out netting and collateral arrangements with respect to their scope of application and legal effects across borders.' Recommendation 9 then advocates that in order not to hamper the effective implementation of resolution measures '[n]ational resolution authorities should have the legal authority to temporarily delay immediate operation of contractual early termination clauses in order to complete a transfer of certain financial market contracts to another sound financial institution' and encourages industry groups such as ISDA 'to explore a way to deal with this issue in a master agreement'.[10] The BCBS states that the limitations on the exercise of termination rights should be accompanied by certain safeguards, identified to be the following: (i) the moratorium should be restricted to a limited and clearly defined timeframe; (ii) the contracts should be transferred as a whole; (ii) the transfer can only be made to a solvent transferee; and (iv) the contractual rights are preserved in the event of any future default by the transferee.

In a similar way, the FSB recommends in its 2011 Report on Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB Key Attributes), updated in 2014, that the legal framework governing, *inter alia*, contractual netting should be clear, transparent and enforceable during

8 An important consequence of the financial crisis is the global movement for the establishment and cross-border recognition of resolution regimes. For an analysis of this movement, see HAENTJENS (2014) 257.

9 BCBS 2010 Recommendations. The set of recommendations made by the BCBS in this Report resulted from its stocktaking of legal and policy frameworks for cross-border crises resolutions and its follow-up work to identify the lessons learnt from the global financial crisis.

10 Virgós and Garcimartín state that in its 2010 Report (at p 40-42) the BCBS has established two main goals of bank resolution and netting, namely (i) a moratorium on the enforcement of early termination clauses in contracts to strengthen the effectiveness of resolution tools, with adequate safeguards for these termination clauses; and (ii) the cross-jurisdictional differences in respect of netting must not render bank resolution ineffective. The rationale for imposing a temporary stay is that unrestricted close-out netting as a result of a bank resolution might constitute a significant additional threat to the stability of the financial markets. See VIRGóS & GARCIMARTíN (2014) 152.

a crisis or resolution of firms, adding however that it should not hamper the effective implementation of resolution measures.[11] On the other hand, the IMF in its report on Resolution of Cross-Border Banks – A Proposed Framework for Enhanced Coordination of June 2010 draws attention to the fact that whilst banking resolution powers overrule ordinary private property and contractual rights in the interests of wider public interests such as financial stability, it is important that creditors' rights are adequately safeguarded, *inter alia*, by respecting and protecting netting and financial collateral arrangements, potentially subject to the temporary suspension of close-out netting rights in respect of financial contracts transferred to a solvent third party.[12] In particular, the IMF report states that where a credit institution is resolved under a special resolution framework, compensation ought to be available to creditors to ensure that they are left no worse off after the resolution than if the firm had been allowed to fail and go into liquidation.[13]

3.2.3 Private Industry Initiatives

Initiatives for the promotion of close-out netting laws have also been undertaken by associations such as UNIDROIT and ISDA. ISDA is perhaps the prime proponent for the enforceability of close-out netting provisions under national laws as this is of essential importance for the effectiveness of the ISDA master agreement and consequently for the success and growth of the derivatives market.[14] ISDA published a Model Netting Law in 1996, updated in 2002, 2006 and 2018, which may be used by national legislators

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11 FSB 2011 Key Attributes, Section 4, p 10. It is important to note that resolution measures should not be hindered not only domestically, but also cross-border. Mevorach notes that 'host countries are not supposed to protect local interests and grab assets where the resolution process takes due regard of interest of all entities worldwide.' See MEVORACH (2018) 242.

12 IMF 2010 Resolution of Cross-Border Banks, p 21 & Box 7, p 22.

13 *Ibid.* 20. For a discussion on the shortcomings of the FSB Key Attributes when compared to the IMF report, see LASTRA (2015) 177.

14 According to Peeters, the widespread acceptance and use of the ISDA master agreements for OTC derivatives may have been a source of *lex mercatoria* or customary law for the eventual recognition of netting as a market process. See PEETERS (2014) 77. There are diverse views on the status of standard master agreements on close-out netting under the precepts of the *lex mercatoria*. According to Collins, in the context of international financial markets, a leading example of *lex mercatoria* is the cross-border use of the ISDA Master Agreement. The ISDA documentation is believed to provide a comprehensive system of self-regulation, and where problems arose as in the case of the Argentinian sovereign debt swaps, ISDA promptly re-wrote the documents in order to avoid perceived ambiguities. Collins, however, criticises the ISDA documentation as a source of *lex mercatoria* as it fails to take into account externalities, such as the general interest, which gives legitimation to its authority, and it also fails to take into account the *jus cogens*, namely mandatory standards of international relations and protection of human rights. See COLLINS (2011) 3, 11.

in designing their netting laws. The Model Netting Law provides principles which ensure the enforceability of bilateral close-out netting, including on a multi-branch basis, as well as the recognition of statutory temporary suspensions of the exercise of termination rights imposed by national resolution regimes.[15]

UNIDROIT first promoted the enforceability of close-out netting in its 2009 Convention on Substantive Rules for Intermediated Securities (the so-called 'Geneva Securities Convention') which (replicating the provisions of the EU Financial Collateral Directive) recommends a framework for the protection of collateral transactions, providing in its Article 33 that a close-out netting provision concluded as part of a collateral transaction may be operated notwithstanding the commencement or continuation of an insolvency proceeding in relation to the collateral provider or the collateral taker.[16] In 2013 UNIDROIT adopted a set of eight Principles on the Operation of Close-out Netting Provisions intended to provide detailed guidance in the form of minimum standards to national legislators seeking to revise or introduce national legislation on close-out netting. These Principles are designed to improve enforceability of close-out netting in particular in cross-border situations for risk management purposes.[17] The core Principles are Principles 6 and 7 which together provide for the enforceability of close-out netting provisions, both outside and within insolvency. An important exception is made in Principle 8 which incorporates the international regulatory consensus with regard to resolution principles and provides that the Principles are without prejudice to measures 'which the law of the implementing State may provide for in the context of resolution regimes for financial institutions'.

15 ISDA 2006 Guide for Legislators; ISDA 2018 Model Netting Act.

16 UNIDROIT 2009 Convention, Articles 31(3)(j) & 33. This Convention was adopted at a diplomatic conference in Geneva on 9 October 2009. The main purpose of the Convention is to offer harmonised transnational rules for the purpose of reducing the legal risks associated with the holding of securities through intermediaries.

17 UNIDROIT 2013 Close-out Netting Principles, 6. According to Peeters, the UNIDROIT Principles are the outcome of a project that originated in an ISDA proposal dated 2008, which was reactivated in May 2010 following the financial crises. He criticises the Principles for paying little attention to the critical approaches in the legal and economic literature to close-out netting which according to the author is mainly due to the fact that the Principles are based on the international (private industry) consensus with respect to close-out netting being a main contributor to system stability and the reduction of systemic risks. See PEETERS (2014) 82. Soltysinski criticises the UNIDROIT Principles as taking into account only the freedom of contract principle but largely ignoring the important qualification that the autonomy of the parties is limited by public policy mandatory laws aimed at protecting the public interest or eliminating unfair practices. See SOLTYSINSKI (2013) 441.

3.2.4 EU Legislative Developments

From a legislative aspect, EU Member States have implemented a partly harmonised substantive legal framework for close-out netting provisions.[18] The first European attempt to address the issues raised in the Lamfalussy Report was made in the field of payment and securities settlement systems. In 1998 the EU adopted the Settlement Finality Directive which recognises and enforces the process of netting in the settlement of transfer orders in a payment system[19] for the execution of cash or securities transfer orders whose participants are credit institutions and investment firms, or EU branches of foreign credit institutions and investment firms, public authorities or publicly guaranteed undertakings, a central counterparty, a settlement agent, a clearing house or a system operator.[20] This Directive provides in Article 3 that netting operating in relation to transfer orders in a payment or securities settlement system is to be legally enforceable and binding on third parties even in the event of an insolvency proceeding, including in cases where the transfer order has been entered into the system after the moment of opening of the insolvency proceeding if the system operator can prove that it was neither aware nor should have been aware of the opening of the insolvency proceeding. This Directive aims to reduce systemic risk associated with operating and participating in payment and securities settlement systems, in particular risks associated with the insolvency of a participant in a system.[21] The Directive also provides a private international law rule which states that in the event of a participant's default, the rights and obligations in connection with the participation in a payment or securities settlement system are determined by the law governing that system and not the law governing the insolvency of the participant which must be the law of a Member State.[22]

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18 The EU lacks a comprehensive or stand-alone close-out netting regime. For a discussion of the shortcomings of the current 'dispersed' regime and a proposal for a new netting regime, see EFMLG 2004 Netting Report.

19 A system is generally defined in Article 2(a) of the Directive to consist of a formal arrangement between three or more participants (excluding the system operator of that system, a possible settlement agent, a possible central counterparty, a possible clearing house or a possible indirect participant and excluding an arrangement entered into between interoperable systems) with common rules and standardised arrangements for the clearing or execution of transfer orders between the participants designated by a Member State as covered by the Directive.

20 See Article 2(f) of the SFD.

21 This is confirmed by the European Commission in its Evaluation Report on the Directive: 'The SFD was the Community legislator's response to the concerns identified by the Committee on Payment and Securities Systems (CPSS) under the auspices of the Bank for International Settlements regarding systemic risk.' See EUROPEAN COMMISSION 2005 SFD Evaluation Report, 3.

22 See Article 9(2) of the SFD.

In 2001 the EU adopted a private international law rule on the choice of law provision in netting contracts through the Banks Winding-Up Directive. This Directive introduces the home State control principle for insolvencies of credit institutions with branches in other Member States, inspired by the principle of home State supervision initially laid down in the Second Banking Directive.[23] It originally governed only the insolvency proceedings of credit institutions, but its application has been extended to investment firms by the BRRD.[24] The Banks Winding-Up Directive provides for a number of exceptions to the principle of the application of the home Member State rules as regards the effects of reorganisation measures and winding-up proceedings. One such exception is provided in relation to set-off. Thus, whilst Article 10(2)(c) provides that the law of the home State shall determine the conditions under which set-off may be invoked, Article 23 provides that the adoption of reorganisation measures or the opening of winding-up proceedings shall not affect the right of creditors to demand set-off if the law applicable to the institution's claim allows it. Thus, the law governing set-off in insolvency is split between the *lex fori concursus* and the *lex contractus*.[25] On the other hand, outside of an insolvency situation, Article 17 of Regulation No 593/2008 on the law applicable to contractual obligations (Rome I)[26] provides that where the right to set-off is not agreed by the parties, 'set-off shall be governed by the law applicable to the claim against which the right to set-off is asserted'. In relation to netting, the Banks' Winding-up Directive stipulates in Article 25 that '[w]ithout prejudice to Articles 86 and 71 of Directive 2014/59/EU, netting agreements shall

23 Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, [1989] OJ L386/1.

24 See Article 117 of the BRRD. This amendment was introduced following an observation made in a 2012 Report of the European Commission that there was a lacuna in EU law for an instrument governing the cross-border insolvencies for collective investment undertakings and investment firms. See EUROPEAN COMMISSION 2012 Insolvency Report, 8.

25 For a detailed analysis of the interpretation of analogous provisions contained in the Insolvency Regulation, see VIRGóS & GARCIMARTíN (2004) 11. Wessels notes that such provisions which allow the parties to select the applicable law to the exclusion of the *lex concursus* means that parties can choose the most favourable law in terms of the effects of insolvency on their contracts which could be a non-EEA state. See WESSELS (2006) 364.

26 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), [2008] OJ L 177/6.

be governed solely by the law of the contract governing such agreements.'[27] Article 26 provides a similar rule with regard to repurchase agreements. It has been stated that the use of the word 'solely' and the comparison with the rules on set-off, in particular the lack of clarification regarding voidability and unenforceability, leads to the interpretation that this reference is to the exclusion of the insolvency law of the *forum* even if the selected governing law is that of a jurisdiction outside the EU.[28] This rule is based on the protection of party autonomy whereby the parties can choose the insolvency framework applicable to the enforceability of the close-out netting provision.[29] However, following the financial crisis, this stance was somewhat limited by the BRRD. This Article was amended in 2014 by Article 117 of the BRRD to subject this rule to the provisions of Articles 68 and 71 of the BRRD. The reference to Article 68 relates to the situation whereby the taking of any crisis prevention, suspension of obligations or crisis management measures by a resolution authority is not deemed to be an enforcement event leading to early termination of contracts, whilst Article 71 relates to the power of resolution authorities to impose a temporary stay on the

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27 In the absence of a definition of netting agreement in the Banks Winding-Up Directive, there is no reason to assume that the term should not include also close-out netting agreements. See MOSS *et al.* (2017) 108. According to these authors, the reference to the *lex contractus* could also refer to the law of a non-EEA jurisdiction with the consequential disadvantages of different treatment of creditors and depositors. *Ibid.* 107. Garcimartín *et al.* note that Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings [2015] OJ L 141 (the Recast Insolvency Regulation) does not provide for a similar provision as Article 25 of the Banking Winding-up Directive but they consider that a combined reading of Article 7 and 9 of the Recast Insolvency Regulation can be broadly construed to include close-out netting within the scope of Article 9 since otherwise the result in a contractual relationship between a company and a bank it would be contradictory that the close-out netting provision is governed in accordance with the *lex contractus* only when the bank becomes insolvent. See HAENTJENS & WESSELS (2019) 208. For a detailed commentary of the EU Recast Insolvency Regulation, see WESSELS (2017).

28 See in this respect, WESSELS (2015), para 10638; PAECH (2014) 435; EFMLG 2004 Netting Report 38, 40; PEETERS (2014) 79.

29 VIRGóS & GARCIMARTíN (2014) 157; BöGER (2013) 256. In the Council's statement of reasons for the introduction of this provision, it is stated that:

> 'Such agreements are commonly used on the financial markets and the Council considers that the special function of such contracts requires a derogation from the principle of universal application of home Member State law in order to protect the functioning of the financial markets and to ensure legal certainty for the contracting parties.'

See Common Position EC No 43/2000 adopted by the Council on 17 July 2000 with a view to adopting Directive 2000/…/EC of the European Parliament and of the Council of … on the reorganisation and winding-up of credit institutions, [2000] OJ C 300/13.

exercise of termination rights under private contracts.[30] This amendment seeks to ensure that even if the law of a non-EU Member State is selected to govern the netting agreement, this does not frustrate the preventive or resolution measures of failing EU credit institutions or investment firms.[31]

This development was followed in 2002 by the issue of the Financial Collateral Directive which may be considered as the most important milestone in the harmonisation of EU close-out netting regimes. This Directive introduces an EU framework for financial collateral arrangements. It applies only to arrangements concluded between specified parties, such as credit institutions and supervised financial institutions, including a possibility for Member States to extend the application to companies concluding a financial collateral arrangement with the former. The financial collateral must be provided and should be evidenced in writing. Article 7 of the Financial Collateral Directive provides that Member States shall ensure that a close-out netting provision can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of either of the parties and notwithstanding any purported assignment, judicial or other attachment or disposition. Member States are further obliged to ensure that the operation of a close-out netting provision is not subject to certain requirements, such as prior notice and official approval, unless otherwise agreed by the parties.

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30 It has been stated that this amendment does not avert all ambiguity since in order to protect the exercise of resolution powers, the amendments should have extended protection also to the *lex resolutionis* in relation to Articles 69 and 71 regarding the resolution authorities' powers to suspend certain obligations and to restrict the enforcement of security interests as well as Article 49 on the exercise of the bail-in power in relation to derivatives. See Francisco Garcimartín, 'Resolution Tools and Derivatives', in HAENTJENS & WESSELS (2014) 193.

31 No similar clause on the governing law of netting agreements exists in either the EU Recast Insolvency Regulation governing insolvency proceedings of non-supervised institutions or in the Solvency II Recast Directive (Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) (recast) [2009] OJ L 335/1) in relation to insurance undertakings. In the absence of specific rules on governing law on netting arrangements, it is presumed that in case of both Solvency II and the Recast Insolvency Regulation the general rules apply, referring the question of enforceability of close-out netting to the *forum* law. The predecessors of these legal acts, Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, [2000] OJ L 160/1, and, insofar as concerns the relevant parts on insolvency proceedings of cross-border insurance undertakings, Council Directive 2001/17/EC of 19 March 2001 of the European Parliament and of the Council on the reorganisation and winding-up of insurance undertakings, [2001] OJ L 110/28, also did not contain provisions on the governing law of netting agreements, although one draft version of the EU Recast Insolvency Regulation did contain a provision similar to Article 25 of the Banks Winding-Up Directive. This provision was dropped in the final version of this recast Regulation. See Article 9 of the Recast Insolvency Regulation and Article 288 of the Insolvency II (Recast) Directive.

The recommendations of the BCBS and FSB on the effective implementation of resolution measures in the banking sector have been implemented by the adoption in 2014 of the EU Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation.[32] Both the Directive and the Regulation determine the rules how failing credit institutions and certain investment firms are restructured and how losses and costs are allocated to the failing institution's shareholders and creditors. However, whilst the Directive relies on a network of national authorities and resolution funds to resolve an institution, the Regulation provides for a central decision-making process (mainly through the Single Resolution Board) to ensure that resolution decisions in respect of institutions supervised under the Single Supervision Mechanism (SSM)[33] are taken effectively, avoiding uncoordinated action.[34] This EU resolution regime, whilst safeguarding the effectiveness of resolution measures from termination rights granted to creditors under financial contracts, also seeks to protect the integrity of close-out netting provisions. Thus, resolution authorities are empowered to suspend the exercise of contractual termination rights until midnight of the day following the publication of a notice of the adoption of resolution measures to enable them to decide on specific resolution actions, e.g. to transfer all the obligations subject to a close-out netting provision to a solvent bridge institution, and to put the necessary measures into effect. This is intended to stall the possibility of a counterparty run and the fire sales of its assets, effectively preserving the viability of the failing institution and enabling its orderly resolution. However, this EU regime makes it mandatory on the resolution authorities that if they decide to transfer the obligations to another entity, they can only transfer in whole, or not at all, the obligations covered by a close-out netting provision.

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32 As noted in the Introduction, both legal acts have been amended by so-called the BRRD II Directive and the SRM II Regulation. The latter will apply from 28 December 2020.

33 The Single Supervisory Mechanism (SSM) is the name for the mechanism which has granted the European Central Bank a supervisory role to monitor the financial stability of significant credit institutions based in euro area Member States starting from 4 November 2014. Member States outside the euro area may also voluntarily participate. The SSM is the first pillar of the EU Banking Union and will function in conjunction with the Single Resolution Mechanism (SRM) and a Single Resolution Fund. See Council Regulation (EU) No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, [2013] OJ L 287/63.

34 Resolution decisions are taken centrally by the Single Resolution Board (SRB) to ensure a coherent and uniform approach of the resolution rules. The SRB also monitors the execution by the national resolution authorities of its decisions at national level. The SRB will apply the Single Rulebook on bank resolution provided in the Bank Recovery and Resolution Directive in the euro area Member States just as this is applied by national resolution authorities in the other Member States. As regards the relationship between the SRM Regulation and the Bank Recovery and Resolution Directive, see Articles 5 and 29 of the SRM Regulation.

3.3 The Regulation of Close-out Netting Provisions under EU Law

Arguably the Financial Collateral Directive and the Bank Recovery and Resolution Directive are the two EU legal acts to have mostly influenced the development of substantive national law on bilateral close-out netting provisions for diverse reasons. The first was instrumental in harmonising to a large degree the laws of Member States on the recognition of close-out netting provisions forming part of a financial collateral arrangement. In fact, it has been seen earlier in this chapter that the FCD solved most of the problems indicated in Barrier 14 of the first Giovannini Report in relation to clearing and settlement arrangements. The second aimed to ensure that the exercise of close-out netting rights does not frustrate the resolution of important banking institutions in pursuance of the goal of financial stability. The effect on the development of close-out netting of each of these legal acts is analysed in more detail below.

3.3.1 The Financial Collateral Directive

The Financial Collateral Directive implements part of the European Commission's Financial Services Action Plan[35] and is based on Article 114 of the Treaty on the Functioning of the European Union, formerly Article 95 of the Treaty establishing the European Community. Article 114(1) empowers the Council and the European Parliament, acting in accordance with the ordinary legislative procedure, to adopt measures for the approximation of laws to achieve the objectives of Article 26. Article 26 provides for the establishment and functioning of the internal market. The scope of this Directive is therefore shaped by considerations of promoting the single market. In terms of the principle of proportionality, the Directive does not go beyond a minimum regime relating to the use of financial collateral which cannot be sufficiently achieved by Member States.[36]

The Directive aims to achieve legal certainty for financial collateral arrangements by ensuring that national insolvency law provisions do not apply to such arrangements, in particular so as not to frustrate the effective realisation of financial collateral or question the enforceability of certain techniques such as bilateral close-out netting and the provision of additional

35 EUROPEAN COMMISSION 1999 Action Plan. The Directive complements the Commission's wide-ranging efforts in the context of the Financial Services Action Plan to encourage cross-border business in financial services, secure the full benefits of the single currency and develop an optimally functioning European financial market.

36 See Recital (22). For an overview of the implementation of the Financial Collateral Directive by Member States see LöBER & KLIMA (2006); EFMLG 2005 Close-out Netting Regulation.

collateral in the form of top-up collateral and substitution of collateral.[37] This is a clear indication that at the time the Directive was adopted, considerations of efficiency and party autonomy in the design and recognition of financial collateral arrangements were foremost in the mind of the EU legislator and it was readily assumed that insolvency law provisions should not be allowed to interfere with the enforceability of financial collateral arrangements 'in accordance with their terms'.[38] The rapid enforceability of procedures was, at the time of adoption, deemed by the EU legislator necessary to safeguard financial stability and limit contagion effects in case of a default of a party to a financial collateral arrangement.[39] It is apparent that the notion of financial stability envisaged by this Directive favours the solvent counterparty who is enabled to enforce its individual claims upon the insolvency of the other party.

In terms of its personal and material scope, the Directive falls squarely in the domain of the financial markets in conformity with the objective of the Directive to establish stability in the financial sector. Thus, Article 1 of the Directive establishes a regime applicable to financial collateral arrangements where the parties include public authorities, central banks, credit and financial institutions, investment firms, insurance undertakings, central counterparties and other related entities. At the option of Member States, the regime can be extended to persons other than natural persons, including unincorporated firms and partnerships, provided that the other party to the arrangement is an institution as stipulated above. Thus, the Directive excludes natural persons from its personal scope. In terms of the material scope of the Directive, it is stated in Article 1(5) that the Directive applies to financial collateral arrangements defined in Article 2(1)(a) as a title transfer type of arrangement such as a repo or a security type of arrangement such as a pledge. In terms of Article 1(4), the financial collateral must consist

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37 See Recital (5). Prior to the Directive, only collateral provided to a central bank or in combination with participation in a designated system enjoyed protection under Article 9 of the Settlement Finality Directive. In a memo of the European Commission of 30 March 2001, the Commission explained that the Directive aims to overcome differences in Member States own legal traditions, in particular as regards insolvency law and perfection and realisation of collateral. For participants in the EU financial market this means having to adjust to a different set of rules for each Member State in which they do business, which is costly and problematic. See EUROPEAN COMMISSION 2001 FAQs, 2.

38 This is confirmed by Article 4(5) of the Directive.

39 See Recital (17). This Recital, however, also foresees that the rights of the collateral provider and third parties should continue to be protected and Member States should keep a posteriori judicial control and provision of judicial remedies in relation to the realisation and valuation of financial collateral and the calculation of financial obligations.

of cash,[40] financial instruments or credit claims. Cash consists of money credited to an account in any currency or similar claims for the repayment of money such as money market deposits. Financial instruments refer to shares, negotiable bonds or securities giving rights to acquire such shares or bonds. Credit claims refer to bank loans. The financial obligations that are secured by a financial collateral arrangement may consist of present or future, actual or contingent or prospective obligations, including obligations arising under master agreements and similar arrangements.

3.3.1.1 Regulation of Close-out Netting Provisions

Close-out netting is regulated by Article 7 of the Financial Collateral Directive. This provision applies within the confines of the material and personal scope of the Directive described above. Article 2(1)(n) defines a close-out netting provision as a provision of a financial collateral arrangement or of an arrangement of which a financial collateral arrangement forms part. This provision is to be interpreted within the confines of the personal and material scope of the FCD. In *Private Equity Insurance Group SIA v Swedbank AS*[41] the European Court of Justice adopted a narrow interpretation of the material scope and held that the FCD 'is applicable *rationae materiae* only if the collateral is provided and, in order for it to be so applicable, subject to Article 8(2) of this directive, that the collateral be provided before the commencement of insolvency proceedings'.[42] It would thus appear that a close-out netting provision must form part of a financial collateral arrangement or be related to it in cases where the collateral has been provided, interpreted in the same preliminary ruling to instances where the collateral-giver has been dispossessed of that collateral or is otherwise prevented from disposing of it.[43]

Recital (14) stipulates that close-out netting provisions are being protected under the Directive as they enable market participants 'to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty [...]'. It is evident that the primary scope for protecting

40 In *Private Equity Insurance Group SIA v Swedbank AS* [2016] C-156/15, the European Court of Justice held in a preliminary ruling that the FCD incorporates a wide definition of cash which is not limited to cash deposited in an account used in securities payment and settlement systems even though the FCD originated as a further measure to the Settlement Finality Directive. On the other hand, the court gave a restrictive interpretation of the requirement in Article 2(2) of the FCD that the financial collateral be provided 'so as to be in the possession or under the control of the collateral taker' and held that some form of dispossession is required to ensure that the collateral taker is actually in a position to dispose of the collateral when an enforcement event occurs.

41 [2016] C-156/15.

42 *Ibid.* para 52.

43 *Ibid.* para 44.

close-out netting provisions under the Financial Collateral Directive is to safeguard their risk mitigation function. The approach is therefore inclined towards the protection of the private benefits accruing to parties of a close-out netting agreement.

Article 7 postulates a close-out netting protection clause which, at first glance, appears to grant full recognition to contractual freedom in the formulation and enforceability of close-out netting provisions. Article 7 obliges Member States to ensure that close-out netting provisions can take effect in accordance with their terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of either of its parties and notwithstanding any purported assignment, judicial or other attachment or other disposition in respect of such rights. In order for a close-out netting to be effective in its own terms it is important that the provision is drafted so as to provide clearly for those events which will trigger its applicability.

Article 8 then protects financial collateral arrangements (including a close-out netting provision) which come into existence on the day of, but after the moment of the commencement of, winding-up proceedings or reorganisation measures if the collateral taker can prove that he was not aware, nor should have been aware, of the commencement of such proceedings or measures.[44] This provision protects close-out netting provisions from suspect periods and zero-hour rules. According to Keijser, the burden of proof lies with the counterparty of the insolvent party. It will be almost impossible to prove this once the information about the insolvency becomes publicly available, because it is assumed that a counterparty ought to have known about it. There may be a timeframe in national law between the declaration of the opening of insolvency proceedings by the court and the actual publication of those proceedings where it could be presumed that the counterparty was acting in good faith. Still, it may be possible for the counterparty to have known from other sources, for instance through published financial statements of the failing debtor.[45]

The Financial Collateral Directive recognises certain limitations which may be imposed under national law when granting recognition to close-out netting provisions. One reference is made in Article 4(6) which provides that Article 7 is without prejudice to any requirements under national law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commer-

44 Paech comments that this provision leaves a number of implementation options to Member States since the relevant applicable criteria such as the definition of 'knowledge' may differ depending on the jurisdiction, as there is no harmonised, exhaustive definition of relevant criteria. Paech states that it may be unclear whether the judge of the *forum* will apply the reservations prescribed by the *forum* law even if the law applicable to the relevant close-out netting agreement is foreign. See PAECH (2014) 442.

45 KEIJSER (2006) 324.

cially reasonable manner. According to Peeters, this requirement would, in general, be already set in the close-out netting provision concluded between the parties, in particular if the parties have resorted to a master agreement and should therefore not constitute an additional obstacle to the party autonomy principle.[46] What is perhaps not clear is whether national law setting other obligations on the parties how to calculate the relevant financial obligations, e.g. the time of the valuation of the collateral, would also have to be observed. This may be contemplated under Recital (15) which provides that the Directive is without prejudice to any restrictions or requirements under national law on bringing into account claims, on obligations to set-off or on netting, for example relating to their reciprocity or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement (or of any mandatory legal act leading to the commencement) of winding-up proceedings or reorganisation measures in respect of the collateral provider.[47]

As a result of these provisions, it has been stated that the Financial Collateral Directive does not offer complete certainty in the close-out netting provisions falling under its scope of application.[48] According to Keijser, an important issue which is not regulated by the Financial Collateral Directive regards the moment in time at which the claims of the parties who are subject to close-out should be valued and as such this issue should be determined under national law. It can be argued, however, that if the main rule under Article 7(1) is that close-out netting provisions should be regulated 'in accordance with their terms', the EU legislator intended to give contractual freedom to the parties to establish matters not covered by the Directive. Hence, in the absence of a mandatory rule under national law, it is expected that this issue is also determined by the contractual freedom of the parties.[49] National law can impose various mandatory conditions such as the mutuality or reciprocity of the obligations subject to close-out netting. It is equally possible that national law has a say on the issue whether a claim comes into existence prior to the moment that the insolvent party's counterparty came to know or ought to have known of the insolvency, or after that moment. This would be the case of rules on voidable preferences which aim to restrain giving a creditor a preferential position to the detriment of all

46 PEETERS (2014) 80.

47 According to Paech, Recital (15) recognises the concerns of national policy makers on losing control over national policies regarding the relationship of the insolvent estate with its creditors, in particular on the scope of the close-out netting provision in relation to the *pari passu* principle notably by defining details of the scope of avoidance and similar powers of the insolvency practitioner or insolvency court. See PAECH 2014 449.

48 KEIJSER (2006) 292.

49 *Ibid.* 293.

other creditors.[50] On the other hand, it is uncertain whether Recital (15) may allow national law to impose requirements that the obligations being netted must be of the same kind. Thus, would national law determine whether cash and securities can be netted out under a repo or a securities lending contract. Keijser is of the opinion that to allow this to be determined by national law would go against the general aim of Recital (14) and Article 7 which are intended to guarantee the enforceability of close-out netting provisions in contracts that relate to cash and different kinds of securities such as a repo agreement.[51] However, it is arguably doubtful whether these provisions of the Financial Collateral Directive can be so widely interpreted as to cover instances of cross-product netting arising under master master netting agreements such as the Cross-Product Netting Master Agreement which may go beyond the confines of this Directive.[52]

A significant change in relation to the recognition granted to close-out netting provisions has been brought into effect by the BRRD in 2014. Article 118 of this latter Directive amends the Financial Collateral Directive by adding a new paragraph to Article 1 which provides that Articles 4 to 7 are disapplied in relation to any restriction on the enforcement of financial collateral arrangements or any restriction on the effect of a security financial collateral arrangement, any close-out netting or set-off provision imposed under the BRRD or to similar restrictions imposed under the laws of Member States to facilitate the orderly resolution of supervised entities. The BRRD also amends Article 9a to provide that the Financial Collateral Directive is without prejudice, *inter alia*, to the provisions of the BRRD. The effect of these amendments is to subordinate the application of the provisions of the Financial Collateral Directive to those of the BRRD.[53] The implications of this in relation to party autonomy and close-out netting will be analysed below.

3.3.2 The Bank Recovery and Resolution Directive

Following the financial crisis of 2008 and 2009, banking regulators and legislators recognised that established insolvency law procedures do not provide the tools needed to manage financial difficulties affecting complex banking

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50 This reference in Recital (15) to rules of national law reflects the approach taken in Recital (16) and Article 8(4) of the Financial Collateral Directive which also refer to general rules of national insolvency law relating to voidance of transactions which were entered into during a prescribed period before insolvency and are to the detriment of the other creditors.

51 See KEIJSER (2006) 303.

52 For instance, the Financial Collateral Directive does not appear to cover instances where deposits may be netted against repo agreements. Moreover, in most instances master master netting agreements may not form part of a financial collateral arrangement, even in the wider meaning of this clause.

53 According to Sumpter and Blundell, the effect of this subordination of laws is that on the exercise of BRRD resolution powers only those safeguards and protections under the BRRD will be available, and not those under the FCD. See SUMPTER & BLUNDELL (2016) 82.

organisations. In response to this need, the Single Resolution Mechanism Regulation and the Bank Recovery and Resolution Directive establish a common EU framework of rules and powers for regulators to intervene and manage credit institutions in difficulty. This framework is intended to achieve five objectives, namely ensuring the continuity of critical functions, avoiding financial instability and maintaining market discipline, protecting public funds by minimising reliance on public financial support, protecting depositors and investors, and protecting client funds and client assets.[54] In order to achieve these objectives, the BRRD provides for resolution tools which include the sale of business to a third party, the powers to set up a bridge institution to hold the business of the institution pending a sale to a third party, a power to separate assets (into good and bad assets) and transfer them into two or more vehicles, and bail-in, *i.e.* the write-down and conversion powers in relation to liabilities in accordance with Article 43 of the BRRD.[55]

Similar to the Financial Collateral Directive, the legal base of the BRRD is Article 114 of the Treaty on the Functioning of the European Union dealing with the approximation of laws intended to achieve the objectives of the establishment and functioning of the internal market. The BRRD applies to credit institutions and investment firms including their branches established outside the EU, financial holding companies, mixed financial holding companies, mixed-activity holding companies and their subsidiary financial institutions.[56] In general terms, the BRRD interferes with close-out netting provisions in two ways. First it gives resolution authorities the statutory powers to trigger the application of those provisions in order to apply the bail-in tool in relation to derivatives. Second, it excludes or delays the rights of the counterparty to trigger the application of those provisions in order to enhance the effectiveness of other resolution tools, such as the transfer of business. These powers granted to resolution authorities are counterbalanced by important safeguards. One important safeguard is specified in Recital (95) of the BRRD which states that in order to preserve legitimate

54 See Article 31(2) of the BRRD. It may not be possible to meet all objectives when exercising resolution powers. Thus, it may not be feasible to protect depositors without recourse to public funds. The resolution authority's task is therefore to balance competing objectives by means of subjective judgments. See KING & WOOD (2013) 641.

55 See Article 37(3) of the BRRD. In terms of Article 32(1) of the BRRD, resolution powers can only be used if all of the following conditions are met: (i) the institution is failing or is likely to fail, defined under Article 32(4) to include not only traditional insolvency standards such as inability to pay debts as they fall due and balance sheet insolvency, but also failure to maintain sufficient regulatory capital and a situation where public financial support is needed to prevent serious disturbance to the economy of a Member State or to preserve financial stability; (ii) there is no reasonable prospect that any other action, including the use of the regulator's powers, would avoid failure; and (iii) resolution action is necessary in the public interest.

56 See Article 1(1)(a) to (e) of the BRRD.

capital market arrangements in the event of the transfer of some, but not all, of the assets, rights and liabilities of a failing institution, it is appropriate to include safeguards to prevent the splitting of linked liabilities, rights and contracts with the same counterparty covered by *inter alia* close-out netting agreements so that resolution authorities are bound to transfer all linked contracts within a protected arrangement or leave them all with the residual failing institution. The balance sought to be achieved by the BRRD between on the one hand, protecting the effectiveness of resolution measures in order to safeguard financial stability and, on the other, preserving the reliability of, and risk mitigation factor attained through, close-out netting, will be examined below.

3.3.2.1 Limitations on the Exercise of Close-out Netting Rights

It appears to have been the intention of the EU legislator to capture all possible configurations of netting arrangements (*i.e* not only those foreseen in the Settlement Finality Directive and the Financial Collateral Directive) to ensure the effectiveness of resolution measures. This is apparent in the wide definition of 'netting arrangement' provided in point (98) of Article 2(1) of the BRRD which includes a number of netting possibilities. The term 'arrangement' itself denotes both formal contractual situations and less informal arrangements agreed or applicable between counterparties.

There are a number of provisions in the BRRD which, directly or indirectly, affect or relate to the three constitutive elements of close-out netting, namely termination, valuation and determination of a net balance. The first such provision is Article 49 on the exercise of the write-down and conversion tool (*i.e.* the bail-in tool)[57] in relation to derivatives. This Article gives power to the resolution authority to itself exercise the termination and valuation rights under existing close-out netting agreements.[58] Article 49 aims to allow resolution authorities to freely exercise the write-down and

57 The bail-in tool, as opposed to bail-out, means that losses suffered by a distressed institution are not paid by taxpayers but by its shareholders or other stakeholders such as creditors. The bail-in tool, which should meet the conditions of Articles 43 and 44 of the BRRD, is said to satisfy a double test: (i) it must respect, as far as possible, the insolvency statutory order of priorities and the *pari passu* treatment of creditors, and (ii) it must leave no creditor worse off than if the failed entity had gone into formal insolvency proceedings.

58 The BRRD gives power to the resolution authority to extend the list of liabilities excluded from bail-in on a case-by-case basis on the grounds listed in Article 44(3) which includes the prevention of a severe disruption of financial markets. Thus, when the scope of financial stability is best served by preserving the derivatives business of a failing institution, resolution authorities are expected not to exercise bail-in in respect of derivatives. The power of exclusion is to be exercised 'in exceptional circumstances' and when this is 'strictly necessary and proportionate' to achieve the continuity of critical functions and core business.

conversion powers in relation to derivatives[59] but at the same time sets out two safeguards in favour of close-out netting arrangements.

First, the resolution authorities may exercise these powers only upon or after the closing-out of the derivatives. This protects the single agreement concept of most netting agreements, in particular master agreements, and thus aims to protect the 'all-or-nothing' approach in relation to linked liabilities in a close-out netting agreement in order to protect the determination of the net balance element. It also protects the management of risk exposure sought to be achieved in netting agreements. Moreover, it is only upon closing out that the resolution authority can determine whether a derivative contract gives rise to a liability and what is its exact amount.[60] The resolution authority is thus given power to itself exercise the right to terminate a close-out netting agreement since it is presumed that the solvent counterparty may be reluctant to do so if it stands to lose from the close-out or if the resolution measure does not trigger the close-out mechanism under the agreement as, in terms of the provisions of the BRRD, it is not a trigger event.

Second, this Article protects the valuation clauses of netting arrangements and provides that where derivative transactions are subject to a netting agreement, their valuation shall be determined by the resolution authority or an independent valuer 'on a net basis in accordance with the terms of the netting agreement'. It is clear that the EU legislator has attempted, to the extent possible, to preserve the terms imposed by the netting agreement and to retain intact the netting mechanism insofar as regards valuation of derivatives as stipulated under the netting agreement. Even the European Banking Authority (EBA),[61] when exercising its delegated powers under this Article to adopt regulatory standards specifying methodologies on the valuation of derivatives, is to take into account the methodology for close-out set out in any relevant netting agreement. Perhaps what is not clear is what happens in those instances where national law (referring to both the *lex resolutionis* and the *lex contractus*) imposes conditions on the valuation of derivatives under a netting arrangement.

59 In fact, this provision has been criticised as only providing generalised principles, leaving a substantial degree of discretion to resolution authorities, which may not be conducive to a level playing field in the exercise of this resolution tool. See Victor de Serière, 'Bail-in: Some Fundamental Questions', in HAENTJENS & WESSELS (2014) 171.

60 This is the case since the application of bail-in powers to derivatives may only be conceived when the failing institution is 'out-of-the-money'. See Francisco Garcimartín, 'Resolution Tools and Derivatives', in HAENTJENS & WESSELS (2014) 187.

61 The EBA was established on 1 January 2011 to form part of the European System of Financial Supervision with the main task of contributing to the creation of the European Single Rulebook in banking. It promotes convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector. See the EBA's website at <http://www.eba.europa.eu/>.

Whilst it has been discussed above that the Financial Collateral Directive may be interpreted to give precedence to national law in this matter, the BRRD does not contemplate this situation but refers only to the valuation clauses of the netting agreement.[62]

A second provision affecting the exercise of close-out netting rights is Article 68 of the BRRD which affects the trigger aspect of close-out netting provisions required to initiate the termination phase. Since one of the objectives of resolution regimes is to protect viable parts of an institution under resolution, such regimes must deal with rights of the institution's counterparties to terminate financial contracts. The continuing operation of these contracts may be essential for the viability of the institution's business that resolution measures are seeking to preserve, in particular if they are critical functions of the institution.[63] This Article first regulates the relationship between the BRRD with the netting provisions of the Settlement Finality Directive and the Financial Collateral Directive by providing that a crisis prevention measure, a suspension of payment or delivery obligations,[64] or a crisis management measure taken in relation to an entity under the Directive does not constitute an enforcement event within the meaning of the Financial Collateral Directive or insolvency proceedings within the meaning of the Settlement Finality Directive if substantive obligations under the relevant contract (such as payment or delivery obligations and the provision of collateral) continue to be performed. The effect of this provision is to ensure the continuation of business in relation to payments and security settlement systems and the non-termination of financial collateral arrangements pending any resolution measures to be taken by resolution authorities.

In the same vein, Article 68(3) of the BRRD provides that a crisis prevention measure, a suspension of obligations or a crisis management measure shall not *ipso facto* make it possible for any party to an agreement to exercise, *inter alia*, any termination, netting or set-off rights, if the substantive obligations under the agreement continue to be performed and is intended to protect the implementation of resolution measures aimed at achieving the continuity of the failing institution or the transfer to a bridge bank or a third party. This clause does not affect the exercise of these rights when this is

62 Commission Delegated Regulation (EU) 2016/1401 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principle on the valuation of liabilities arising from derivatives, [2016] OJ L 228/7, sets the rules for the valuation of derivatives contracts, in particular in Article 2. In terms of Article 4 of this Commission Delegated Regulation, for contracts subject to a netting agreement, the single amount shall be determined as defined in the netting agreement.

63 KEIJSER *et al.* (2014) 51.

64 The reference to suspension of obligations in Article 68 if the BRRD was added by Article 1(29) of the BRRD II and constitutes a reference to suspension which may be exercised by resolution authorities under Article 33a of the BRRD.

triggered by events which are not related to the exercise of crisis prevention measures or crisis management measures. This provision applies as a mandatory rule within the meaning of Article 9 of the Rome I Regulation[65] and as a result will apply irrespective of the law governing the netting agreement. Otherwise, by choosing a foreign law, it would be relatively easy for the parties to avoid the application of these powers.[66] This has the effect that a court in an EU Member State is bound to reject the parties' characterisation of a resolution measure as a contractual enforcement event in their contract, notwithstanding that the applicable law of the contract is the law of a third non-EU country. It does not, however, eliminate the risk of incompatible parallel judgments in cases where the resolution forum is an EU Member State and the solvent counterparty brings an action to enforce contractual termination provisions in the court of the third country.[67]

A third provision affecting close-out netting is Article 71 of the BRRD. This Article goes a step further than Article 68 and empowers resolution authorities to temporarily suspend termination rights under a contract with an institution under resolution from the publication of the notice of the resolution action until midnight of the business day following this publication, provided that payment and delivery obligations continue to be performed. This is intended to allow the resolution authority a timeframe within which to decide whether to transfer the obligations covered by the netting agreement to a bridge institution. The temporary suspension, which cannot be extended, is accompanied by certain safeguards. First, during that period, the payment and delivery obligations of the solvent counterparties are also suspended and only become due immediately upon expiry of the suspension period, and, second, the BRRD explicitly provides that the

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65 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), [2008] OJ L 177/6. Article 9 provides, *inter alia*, that provisions regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, are applicable to any situation falling within their scope, irrespective of any contractual governing law.

66 As already seen above, this is reinforced by an amendment to Article 25 of the Banks Winding-Up Directive which provides that the effects of entry into resolution, restructuring or winding-up proceedings on netting agreements will be governed by the law applicable to those agreements, but without prejudice to Article 68 of the BRRD on the general exclusion of the entry into resolution as a termination event and Article 71 on the power to temporarily suspend contractual termination rights. The same amendment has been affected to Article 26 of the Banks Winding-Up Directive in relation to the law applicable to repo agreements.

67 The FSB has expressed a concern that given the cross-border nature of financial relationships where the governing law of the contracts will be a foreign law at least for one of the counterparties, national courts may not be able to enforce a restriction or temporary stay on the exercise of early termination rights imposed under a foreign resolution regime, where the contract in question is governed by the law of the court's jurisdiction or would be unlikely to do so sufficiently promptly to meet the needs of effective resolution. It is therefore important that the restrictions on contractual rights can be enforced across borders. See FSB 2014 Consultative Document, 3.

obligations of the institution under resolution will become due immediately upon expiry of the suspension period.[68] In order to ensure the effectiveness of these measures, the BRRD gives resolution authorities an equivalent power of suspension that may be invoked in respect of the enforcement of security interests.[69]

This Article provides for the following exceptions or qualifications to the temporary suspension of termination rights:

(a) In order to protect the finality of transfer orders in a payment or securities settlement system, this Article provides that the suspension of termination rights does not apply to systems or operators of systems designated for the purposes of the Settlement Finality Directive, central counterparties or central banks.[70] Otherwise, there could result a major liquidity problem in ensuring overall settlement on the business day affected.

(b) A counterparty may exercise termination rights under a contract before the end of the suspension period if it receives notice from the resolution authority that the rights and liabilities covered by the contract shall, in fact, not be transferred to another entity neither will they be subject to the write down or conversion tool.[71]

(c) In the event of a transfer of contractual rights and liabilities, termination rights may be exercised at the end of the expiry of the suspension period, subject to the provisions of Article 68,[72] only on the occurrence of any continuing or subsequent enforcement event by the transferee entity.[73] This assures the new acquirer that those contracts will not be immediately terminated after the transfer.

(d) If the contractual rights and liabilities remain with the institution under resolution and the resolution authority has not exercised the write down or conversion tools, the counterparty may proceed to exercise termination rights under the terms of the contract at the end of the expiry of the suspension period.[74]

A visible effort has been made by the EU legislator to safeguard the close-out netting mechanism of financial contracts and to interfere only in a way which is strictly necessary for the effectiveness of resolution measures. A further consideration is taken into account in Article 71(6) which imposes an obligation on resolution authorities to have regard to the impact of the

68 See Article 69 of the BRRD.
69 See Article 70 of the BRRD.
70 See Article 71(3) of the BRRD.
71 See Article 71(4) of the BRRD.
72 The link with Article 68 of the BRRD presumably refers to the mandatory rule that the taking of resolution action in itself cannot *ipso facto* lead to triggering the termination of the netting agreement.
73 See Article 71(5)(a) of the BRRD.
74 See Article 71(5)(b) of the BRRD.

exercise of imposing a temporary suspension on the orderly functioning of the financial markets. Thus, there is a clear understanding that the exercise of powers is not absolute and a balancing of interests has to take place continuously.

The BRRD grants further protection to netting agreements under the provisions of Articles 76 to 80. Article 76 imposes an obligation on Member States to safeguard a number of arrangements, including netting arrangements, the details of which are further specified in Articles 77 to 80. Of relevance to netting arrangements is Article 77 which prohibits the transfer of some, but not all, of the rights and liabilities that are protected under, *inter alia*, a netting arrangement between the institution under resolution and its counterparties. This is complemented by Article 78 which provides that the transfer of secured obligations is legally ineffective unless the related security arrangements, together with the security assets, are also transferred to the new entity. Article 77 also prohibits the modification or termination of rights and liabilities protected under a netting arrangement. This Article explains that rights and liabilities are to be treated as protected under such an arrangement if parties are entitled to set-off or net those rights and liabilities. An exception arises in respect of deposits covered by a national deposit guarantee scheme which may be extracted by the resolution authority from the rest of the assets, rights and liabilities to ensure their availability for regulatory purposes. In the context of payment and securities settlement systems, Article 80 provides that no transfer of assets or exercise of power by a resolution authority to cancel or modify the terms of a contract which would result in the modification or unenforceability of netting under the Settlement Finality Directive.[75]

75 Commission Delegated Regulation (EU) No 2017/867 of 7 February 2017 on classes of arrangements to be protected in a partial property transfer under Article 76 of Directive 2014/59/EU of the European Parliament and of the Council, [2017] OJ L 131/15, provides in Article 4(1) that (similar to set-off arrangements and security arrangements) bilateral netting arrangements will qualify for protection under Article 76 of the BRRD where they relate to 'rights and liabilities arising under financial contracts or derivatives' and Article 5(2) empowers resolution authorities to exclude from the protection afforded by Article 76(1) of the BRRD arrangements which permit the solvent party to make limited payments or no payments (such as a walk-away clause) to the insolvent party. Article 4 reflects the Technical Advice by the European Banking Authority on classes of arrangements to be protected in a partial property transfer of 14 August 2015 (EBA/Op/2015/15) to the European Commission stating that so called 'catch-all' or 'sweep-up' arrangements would jeopardise the efficiency and feasibility of partial property transfer powers if such arrangements are protected in accordance with their terms when they provide for the set-off or netting of all rights between the parties. *Ibid.* para 10. The national law of Member States implementing the BRRD needs to be interpreted in the light of these restrictions imposed by the Commission Delegated Regulation.

It is evident that the BRRD has put in place a number of safeguards to protect the close-out netting provision. The write down or conversion powers of derivatives covered by netting arrangements may only be exercised in relation to the net position under these arrangements and by using the valuation foreseen in the netting arrangement. The power to suspend the exercise of close-out netting rights only applies if all payment and delivery obligations continue to be performed. The suspension is brief and may only extend until midnight of the following business day. If the transactions covered by the close-out netting provision are actually transferred to a third entity, the resolution authority may not 'cherry-pick' and has to transfer all or none of the transactions. The netting counterparty is free to terminate the transactions if the transferee entity fails to perform the payment or delivery obligations under the netting agreement. In the end, the netting counterparty may find itself in a better position if the transfer takes place since it is presumably dealing with a healthier entity and it may retain its existing hedging positions.

3.4 Preliminary Conclusions

This chapter provided an overview of the sources of the *lex mercatoria* deemed to have strengthened the global recognition of close-out netting and, as a result, to have influenced the development of national close-out netting regimes. Two main sources have been identified, namely the declarations made by international regulatory bodies on the advantages of establishing the legal soundness of close-out netting provisions for the stability of financial systems and the standard market agreements of private market associations, in particular in the derivatives industry, which depended on the enforceability of their close-out netting provisions for the growth of their industry.

Prior to the financial crisis both sources were advocating the protection of close-out netting provisions in accordance with their terms and were generally in agreement in their approach that insolvency law should not hinder whatsoever the enforceability of close-out netting provisions in order to enhance the stability of the financial system. Following the financial crisis, the international regulatory bodies took the lead in issuing declarations on the need to curb the favourable treatment given to close-out netting provisions upon insolvency in relation to failing banking institutions. These bodies advocated the imposition of restrictions on the exercise of close-out netting rights to enable resolution authorities to effectively exercise bank resolution measures as this was deemed necessary for financial stability purposes. One main restriction advocated by these bodies was the temporary suspension of the exercise of contractual termination rights intended to allow national authorities to transfer the assets and liabilities of the institution in resolution. Gradually, the private industry started taking action to implement these declarations such as ISDA which adopted resolution stay protocols.[76]

EU law has been designated as a third, special source of the *lex mercatoria*. Whilst this third source will have invariably influenced the development of Member State laws, it is not excluded that it could have also influenced third country laws which, for various reasons, resorted to the EU model as a basis for their netting regimes. The regulation of netting under EU law has developed in a piecemeal manner and is mainly centred on the protection of netting from national insolvency laws. Both the Settlement Finality Directive and the Financial Collateral Directive provide for the enforceability of netting notwithstanding the commencement of insolvency proceedings against a participant or a counterparty, even if the enforcement takes place after the commencement of insolvency proceedings provided this was done in good faith. The Banks Winding-Up Directive, on the other hand, sets out a private international law rule on netting agreements which takes the form of a carve-out from the home State principle on which the Directive is based. According to the rule in this Directive, netting agreements are to be governed solely by the law of the contract governing such agreements. Although some interpretation issues arise, this provision serves to support and consolidate the protection of close-out netting provisions in accordance with their terms and shields netting contracts from the insolvency law provisions of the home Member State.

The analysis of EU netting law has focused on the provisions of the Financial Collateral Directive and the BRRD as these are directly relevant to the research question. The enforceability of close-out netting provisions under the Financial Collateral Directive is based on the principle of party autonomy and recognises the enforceability of close-out netting provisions according to their terms notwithstanding the commencement of insolvency proceedings. This protection is based on the need to safeguard financial stability and limit systemic risk. Limitations are set on the unrestricted applicability of party autonomy by Recital (15) which provides that the Directive is to apply without prejudice to any restrictions or requirements under national law on netting, giving as examples the reciprocity of the obligations or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement of insolvency proceedings.

In the aftermath of the financial crisis the EU legislator re-considered its approach on the effects on systemic risk caused by the exercise of contractual termination rights. This is reflected in the adoption of the BRRD which

76 Mevorach criticises the FSB Key Principles as being too insufficiently precise and incomplete 'to create a strong enough obligation to adhere to a uniform regime'. See MEVORACH (2018) 247. This criticism may be levied at most of the declarations made by the international regulatory bodies cited in this chapter (maybe with the exception of the EU sources) so that there remains a wide margin of discretion in the way in which national legislators implement them.

has amended the provisions on netting found in the other three Directives with the intention of protecting the effectiveness of resolution measures in the interests of financial stability. This Directive is limited in personal scope since it applies only to credit institutions and investment firms. It provides that the taking of resolution measures shall not be deemed to constitute an enforcement event under the Financial Collateral Directive or insolvency proceedings under the Settlement Finality Directive. It also provides that the private international law rule applying under the Banks Winding-Up Directive which refers to the law governing the netting agreement shall apply without prejudice to the resolution authority's exercise of powers under the BRRD. These relate to the fact that the taking of any crisis prevention measure or crisis management measure is not deemed to be an enforcement event leading to early termination of contracts and the selected law should apply without prejudice to the powers of the resolution authority to impose a temporary stay on the exercise of termination rights in relation to private contracts.

The scope of Part I has been to provide an introduction to the concept of close-out netting, with particular focus on its relationship with set-off, on the interaction of close-out netting with national insolvency and resolution laws and on the sources of the *lex mercatoria* which were instrumental to both develop close-out netting as a market tool and to influence national legislators to give statutory recognition to this concept. These features will be analysed again in Part II from the point of view of the laws of the three selected jurisdictions and will form the basis for the replies to the three sub-questions raised in the Introduction under the laws of these jurisdictions.

Part II

National Close-out Netting Regimes

4 Insolvency Close-out Netting under English Law

4.1 Overview of the Regulation of Insolvency Close-out Netting under English Law

This is the first of three chapters dealing with the application of insolvency close-out netting under national law, the first being under English law which hails from a common law jurisdiction and is traditionally considered to give favourable treatment to pre-insolvency contractual entitlements such as insolvency close-out netting.[1] The aim of each of these national law chapters is to provide preliminary (and partial) replies to the three sub-questions raised in the Introduction to this research, i.e. on the influence of set-off rules, insolvency law and resolution regimes on the recognition granted by the legislator to insolvency close-out netting provisions, whilst more conclusive replies will be provided in Part III.

In order to arrive at these considerations, each national law chapter will be similarly structured first to provide a brief overview of the national insolvency proceedings, bank resolution law and the applicable laws which regulate insolvency close-out netting. This is followed in the second part by a comparative analysis of the constitutive elements of the concepts of close-out netting and insolvency set-off as regulated by national law, in the third part by an examination of the way in which close-out netting developed under national law and how it was affected by the promulgation of bank resolution regimes, and in the fourth part by considering the rationale and principles forming the basis of national insolvency law in order to gain insight into whether the regulation of insolvency close-out netting can be understood in the light of any public policy or insolvency goal established by the state.[2]

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1 For an explanation of the English pre-insolvency entitlements regime, see PECK *et al.* (2011) 4.

2 The consideration of national laws is, naturally, based on the same premises of the research question, namely that it is limited to the operation of bilateral insolvency close-out netting considered from a substantive law point of view in the field of the OTC derivatives, repo and securities lending markets in relation to corporate entities, excluding clearing houses and central counterparties as well as payments and securities settlement systems, except where references to these serve to strengthen or illustrate a legal argument that is being made.

Insolvency Rules

The insolvency rules of a jurisdiction form the backdrop against which a close-out netting provision operates when it is triggered by the occurrence of an insolvency event. It is therefore deemed relevant to commence with a brief overview of the main insolvency rules which are affected by the exercise of a close-out netting provision. It is not intended to delve into a detailed explanation of these rules, but it will suffice to give an idea of how English insolvency proceedings operate in order to give a context to the arguments made in this chapter.[3] This part deals only with the domestic procedural aspects of English insolvency law and does not consider cross-border insolvencies.

Under English law, insolvency proceedings are predominantly regulated by the Insolvency Act 1986, as further elaborated by the Insolvency (England and Wales) Rules 2016.[4] There are four main types of insolvency proceedings under English law, namely liquidation or winding-up,[5] administration,[6] receivership[7] and voluntary arrangement[8] of which the first two are more relevant for the purposes of this research. Liquidation leads to the dissolution of a company and consists in preserving the company's assets, the determination of its liabilities and the distribution of its assets among its creditors. Liquidation can commence following a compulsory winding-up order by a court upon a petition by a creditor or a voluntary winding-up either by the company's shareholders (in the case the company is still solvent) or by its creditors. In both types of liquidation, a liquidator is appointed to take control of the company's affairs[9] for the purpose of its beneficial winding up and eventual distribution of its assets

3 For a more detailed explanation of English insolvency law proceedings, see McKNIGHT (1996, updatable), para 38 *et seq.* For an explanation of the historical development of English insolvency law, see FLETCHER (2017) 1-015; VAN ZWIETEN (2018) 9.

4 S.I. 2016/1024. These Rules replaced the former Insolvency Rules 1986 (S.I. 1986/1925) with effect from 6 April 2017.

5 See section 73 *et seq.* of the Insolvency Act 1986.

6 See section 8 *et seq.* of the Insolvency Act 1986.

7 See section 28 *et seq.* of the Insolvency Act 1986. Administrative receivership is one of three forms of receivership whereby an administrative receiver is appointed by a security holder with a floating charge over the whole or substantially the whole of the company's assets to hold and realise the security for the benefit of the secured creditor. This form of procedure is no longer in common use since section 250 of the Enterprise Act 2002 prevented, with some exceptions, the appointment of administrative receivers with respect to security taken on or after 15 September 2003.

8 See section 1 *et seq.* of the Insolvency Act 1986. A voluntary arrangement is essentially a form of compromise amongst a company's creditors whereby creditors of the company representing seventy-five per cent of the value of the debts of the company can bring about a moratorium on other creditor action whilst the arrangement is in place.

9 See section 91 of the Insolvency Act 1986.

to creditors.[10] His duties are owed to the company and to the general body of creditors. Administration is essentially a rehabilitation procedure introduced by section 248 of the Enterprise Act 2002 to promote the preservation of business[11] and is usually commenced by the company. The promulgation of the administration procedure gave rise to what become known in English insolvency law as the 'rescue culture', giving preference to reorganising companies so as to restore them to profitable trading and enable them to avoid liquidation. An administrator may be appointed through a court or out-of-court procedure.[12] In both instances, the administrator is given statutory powers to rehabilitate the company. When it is not possible to restore the business to profitable trading, the administrator may apply to the court to wind up the affairs of the company thereby 'achieving a better result for the company's creditors as a whole than would be likely in the company were wound up' under liquidation proceedings.[13] A particular form of administration that has gained popularity is the pre-packaged administration, or 'pre-pack' as it is known, in which a company in financial difficulty, with the approval of its dominant creditors and the involvement of an insolvency practitioner as prospective administrator, reaches an agreement for the sale of its business or all of its assets shortly before going into administration. The agreement is placed in escrow (*i.e.* in custody or trust) pending the appointment of the administrator and the sale takes effect immediately on such appointment.

Certain principles of English insolvency law are directly impacted by the enforceability of close-out netting provisions. One important principle is the so-called 'stay'.[14] On the making of a winding up order in liquidation and on the commencement of administration, individual legal actions against the debtor are stayed, except with the leave of the court, and attachments and other forms of execution proceedings that have not been completed are avoided in order to transfer control of the company's assets

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10 English insolvency law establishes a ranking of payment in a liquidation as follows: (i) ownership of assets, fixed security over assets and insolvency set-off; (ii) liquidation expenses; (iii) preferential creditors, *i.e.* claims for occupational pension scheme contributions, unpaid employees' remuneration and coal and steel contributions; (iv) secured creditors with a floating charge; (iv) unsecured creditors (other than preferential creditors); and (v) company members. See, in particular, sections 175 and 328 of the Insolvency Act 1986.

11 This is the primary objective of administration. For other, subsidiary, objectives see para 3, Schedule B1 of the Insolvency Act 1986.

12 This out-of-court procedure is available to certain secured creditors or the company or its directors by filing a notice of appointment and other prescribed documents. See paras 14, 18(1) 22 and 29(1), Schedule B1 of the Insolvency Act 1986.

13 Para 3(b), Schedule B1 of the Insolvency Act 1986.

14 See, for instance, sections 126 & 130(2) and paras 42 & 43, Schedule B1 of the Insolvency Act 1986.

and affairs to the liquidator or administrator. A second important principle relates to the measure that may be taken by the liquidator relates to the right to 'disclaim onerous property'.[15] Under section 178(4), the disclaimer operates to determine the rights, interests and liabilities of the insolvent company under the disclaimed contract, although this does not affect the rights or liabilities of third parties. Any loss or damage sustained by the other party to the contract in consequence of the disclaimer is, under section 178(6) provable[16] in the liquidation. The right of the liquidator to disclaim raises the issue of 'cherry-picking' whereby the liquidator is entitled to decide which particular contracts or rights to assets to disclaim, thereby bringing them to an end, and which he wishes to enforce. The solvent party may therefore find itself in a position of having to continue to perform under the contracts which are profitable for the insolvent company whilst having to prove in the insolvency for the loss it has suffered in consequence of the termination of the disclaimed contracts. Third, an important principle of English insolvency law is that unsecured creditors rank *pari passu* (*i.e.* rateably) in their entitlement to the distribution of the insolvent debtor's assets in a winding-up and where there is to be a distribution in an administration.[17] A procedural measure giving effect to this principle is that arrangements between a debtor and certain of its ordinary creditors will be struck down if they have the effect, even unintentionally, of putting the claims of those creditors ahead of the debtor's other unsecured creditors without their consent in the insolvent winding-up of the debtor.

The Banking Act 2009 provides specialist legislation dealing with the insolvency of deposit-takers, namely credit institutions[18] and building societies. It follows the adoption of the Banking (Special Provisions) Act 2008, which was a temporary piece of legislation allowing the UK authorities to take action to deal with the failure of Northern Rock plc as well as later instances of bank failures.[19] The Banking Act 2009 was extended to cover investment banks in 2011 by virtue of the Investment Bank Special Admin-

15 See section 178 of the Insolvency Act 1986. Onerous property is defined in section 187(3) to include any unprofitable contract, and any other property of the company which cannot be sold or which may give rise to a liability to pay money or perform any other onerous act.

16 This term refers to the procedure for proof of debt, set out in rule 4.73 of the Insolvency Rules 1986, whereby a creditor of an insolvent debtor, wishing to be considered for the purposes of voting and payment of the so-called 'dividend' from the proceeds of the liquidation of the insolvent estate, is required to submit a formal claim to the liquidator.

17 See sections 107 and 328(3) of the Insolvency Act 1986 and rule 14.12 of the Insolvency Rules 2016.

18 See, in this respect, the definition of 'bank' in section 2 of the Banking Act 2009 and the definitions of 'banking institution' in article 2 of each of the Banking Act 2009 (Restriction of Partial Transfers Order) 2009 (S.I. 2009/322) and the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 (S.I. 2014/3350).

19 See Louise Verrill & Paul Durban, 'United Kingdom (England and Wales)', in HAENTJENS & WESSELS (2015) 526.

istration Regulations 2011.[20] The Banking Act sets out three types of procedures to deal with failed or failing banks, namely resolution, insolvency[21] and administration,[22] so that these are no longer subject to the insolvency proceedings of the Insolvency Act 1986 if they hold insured deposits. The resolution regime consists of stabilisation options which are essentially powers conferred on designated authorities, namely the Bank of England, the Treasury, the Financial Conduct Authority and the Prudential Regulatory Authority, involving transfers of the assets and liabilities of banks to either (i) a private sector purchaser, (ii) a 'bridge bank' or (iii) temporary public ownership, and also the bail-in option providing for the transfer of securities issued by a specified bank to be transferred to a resolution administrator or another person.[23] Under the bail-in option, securities may also be cancelled, reduced or converted into equity instruments. Gleeson & Guynn explain that bank resolution is an alternative to insolvency and may be applied only if some form of public interest test in their use is met. According to these authors, the idea is to make insolvency the norm and resolution the exception.[24] The Code of Practice which accompanies the Banking Act 2009 notes that:

> '[t]he Bank of England may only exercise a stabilisation power if satisfied that the exercise of the power is necessary having regard to the public interest in the advancement of one or more of the special resolution objectives, and that one or more of the special resolution objectives would not be met to the same extent by the winding up of the bank – including through the use of the bank insolvency procedure […] The test of "necessity" is a high one.'[25]

20 S.I. 2011/245.

21 See Part 2 of the Banking Act 2009. The insolvency procedure leads to the liquidation of the bank. In terms of section 95, there are three grounds for the application of a bank insolvency order, namely that a bank is unable, or likely to become unable to pay its debts; that the winding up of the bank would be in the public interest and that the winding up of the bank would be fair. The bank insolvency procedure may be resorted to by the authorities if they do not consider it appropriate to seek to resolve the failing bank through use of one of the stabilisation options. See Louise Verrill & Paul Durban, 'United Kingdom (England and Wales), in HAENTJENS & WESSELS (2015) 530.

22 See Part 3 of the Banking Act 2009. The procedures for bank administration are of a consequential nature since they deal with the part of a bank's business that remains with the so-called 'residual bank' when a stabilisation power is used to transfer only some of its assets to a commercial purchaser or a 'bridge bank'.

23 The authorities may use the stabilisation options or resort to the bank insolvency procedure, only when the Prudential Regulation Authority is satisfied that: (a) the bank is failing, or is likely to fail, to satisfy the threshold conditions set out by the Financial Conduct Authority to permit it to carry on regulated activities; and (b) subject to consultation with the Financial Conduct Authority, the Bank of England and the Treasury, it is not reasonably likely that other actions will be taken to enable it to satisfy those threshold conditions. See sections 7 and 96 of the Banking Act 2009. For an effectiveness assessment of the English resolution regime, see CAMPBELL & MOFFATT (2015) 66.

24 GLEESON & GUYNN (2016) 230.

25 HM TREASURY 2017 SRR Code of Conduct, paras 6.24 and 6.25.

Among these objectives, section 4 of the Banking Act 2009 lists the public interest in the stability of the financial system of the UK, the maintenance of public confidence in the stability of that system and the protection of depositors.

The Financial Collateral Arrangements (No. 2) Regulations 2003

The Financial Collateral Arrangements (No. 2) Regulations 2003 (FCAR) is the main substantive English legal act regulating close-out netting in the OTC market. The provisions regulating insolvency close-out netting under the FCAR are regulations 10(1)(b) and 12 to 14, intended to implement Articles 7(1) and 8 of the EU Financial Collateral Directive. It may be noted that the FCAR does not implement Article 7(2) of the EU Directive obliging Member States to ensure that the operation of a close-out netting provision is not subject to formal requirements listed in Article 4(4) of the same Directive, since it is stated in a consultation document issued by HM Treasury on the implementation of the EU Financial Collateral Directive (the FCAR consultation document) that there are no such requirements under English law which affect the operation of close-out netting provisions 'so it is not necessary for the draft regulations to contain any specific provision implementing that part of the Directive.'[26]

In relation to the scope of application of the FCAR close-out netting provisions, regulation 3 of the FCAR provides that a close-out netting provision is a term in a financial collateral arrangement or an arrangement of which a financial collateral arrangement forms part or in any legislative provision.[27] The financial collateral arrangement can be either a title transfer or a security type of financial collateral arrangement. The collateral should consist of cash, financial instruments or credit claims. Whilst the material scope of the FCAR is relatively similar to that of the EU Financial Collateral Directive, the personal scope is significantly wider. The application of the EU Directive is limited to specified financial market participants or corporate entities dealing with a specified financial market participant. Under the FCAR the collateral-provider and the collateral-taker are both defined as 'non-natural persons'.[28] A non-natural person is, in turn, defined to mean any corporate body, unincorporated firm, partnership or body with legal personality except an individual. In terms of the FCAR consultation documentation, the FCAR is made to apply to corporate bodies generally since this was considered consistent with the overall policy objectives and position in UK law, and furthermore it simplifies implementation by avoiding the need for reintroducing elaborate definitions similar to those

26 HM TREASURY 2003 FCAR Consultation Document, para 4.6.

27 For a critique of the definitions used in the FCAR which affect the scope of these same Regulations, see HUGHES (2006) 65.

28 See regulation 3 of the FCAR.

of Article 1(2)(c) of the EU Directive.[29] The question arises why the scope of this regulation was not extended to cover also physical persons, given the general enforceability of close-out netting provisions as highlighted in the FCAR consultation document? The reason provided seems to be a technical one, in the sense that the FCAR was enacted on the basis of the implementing powers of section 2(2) of the European Communities Act 1972[30] and it appeared to the English legislator to be legally unfeasible to extend this legal basis to cover individual business relationships. However, the document declares that English law already recognises the enforceability of close-out netting provisions in these types of business relationships involving individuals or sole traders.[31]

Regulation 12 bases the applicability of insolvency close-out netting on the basis of contractual freedom by providing that a close-out netting provision shall take effect 'in accordance with its terms' notwithstanding that the collateral-provider or collateral-taker under the arrangement is subject to winding-up proceedings or reorganisation measures. The term 'winding-up proceedings' is defined in regulation 3 to include winding up by the court or voluntary winding up in terms of the Insolvency Act as well as bank insolvency under the Banking Act 2009, whilst 'reorganisation measures' include administration, a company voluntary arrangement and the making of an interim order on an administration application in terms of the Insolvency Act. It is interesting to note that reorganisation measures

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29 HM TREASURY 2003 FCAR Consultation Document, paras 2.2 and 2.3. In *R (on the application of Cukurova Finance International Ltd) v HM Treasury* [2008] EWHC2567 (Admin) at [96] the applicant challenged the validity of the FCAR on the grounds that the personal scope goes beyond the scope of Article 1(2)(a)-(d) of the FCD which is limited to the wholesale market as this represented a significant inroad into the rights of unsecured creditors in an insolvency. The judge considered that the time for presenting the application had expired and he did not consider it necessary to extend time so that there is no final judgment on this issue. The judge, however, stated *obiter* that the FCAR struck a different balance than did the FCD but he did not consider that the widening of the scope of protection undermined the objectives of the FCD. Reservations to this *obiter dictum* were made by the UK Supreme court in *The United States of America v Nolan* case ([2015] UKSC 63) where the court noted that the extension of the scope of the FCD was not a matter for the executive (*i.e.* the Treasury which issued the FCAR) to decide, but for Parliament to agree as a matter of primary legislation. The Financial Market Law Committee in a paper of July 2008 entitled 'Issue 132 – Alfa Telecom Turkey Ltd v Cukurova Finance International Ltd and Cukurova Holdings AS: Legal Assessment of an issue raised in the above case, namely the extent to which the Financial Collateral Arrangements (No 2) Regulations 2003 are ultra vires the European Communities Act 1972' concluded that the FCAR were *intra vires* section 2(2)(b) of that Act.

30 Given the cut-off date of 31 December 2019 set for updating this research, the effects of the exit of the United Kingdom from the EU (Brexit) will not be dealt with in this chapter. However, it is important to note that following Brexit, the European Union (Withdrawal) Act of 2018 will repeal the European Communities Act 1972 and will copy into domestic law all directly applicable EU law which will be in operation on exit day. For a general commentary of the impact of a no-deal Brexit on the financial markets, see PERKINS & PAREKH (2019) 652; DOWNE (2019) 658.

31 HM TREASURY 2003 FCAR Consultation Document, para 2.4.

do not also include resolution measures under the Banking Act 2009. The reason for this, as will be examined in more detail below, is that the Banking Act itself regulates the substantive aspects of insolvency close-out netting in relation to its provisions in a manner which is different from that currently obtaining under the FCAR. This is intended to safeguard the effectiveness of bank resolution measures.

The rule in regulation 12 that a close-out netting provision should take effect in accordance with its terms is subject to the condition in its sub-regulation (2) that at the time the financial collateral arrangement was entered into the solvent party did not have knowledge or the constructive knowledge that winding-up proceedings or reorganisation measures had commenced.[32] The solvent party is deemed to possess actual knowledge if it had notice that a meeting of creditors of the other party had been summoned or that a petition for the winding-up of the other party or an application for an administration order was pending or that any person had given notice of an intention to appoint an administrator and liquidation of the other party to the financial collateral arrangement was immediately preceded by an administration of that party.[33] Sub-regulation (4) then provides that certain provisions of the Insolvency Rules 1986, now replaced by the Insolvency Rules 2016, on set-off in administration or on winding-up shall not apply to close-out netting provisions under regulation 12 unless in terms of regulation 12(2)(a) there was knowledge (constructive or actual) of the winding-up proceedings or the reorganisation. In terms of regulation 13, if the relevant financial collateral arrangement came into existence on the day of but after the moment of commencement of the winding-up proceedings or reorganisation measures, the close-out netting provision is legally enforceable if the collateral-taker can show that he was not aware, nor should have been aware, of the commencement of such proceedings or measures. Regulation 14 provides that conversion of foreign currency amounts shall take effect in accordance with the provisions of the close-out netting provision rather than the relevant insolvency set-off rules, namely rule 14.21 of the Insolvency Rules 2016.

Fawcett considers the proposition whether the FCAR covers transactions entered into after insolvency when these are governed by a master agreement entered into prior to the insolvency. He considers that such a transaction may be deemed to be a future obligation at the time when the master agreement was executed and would fall under the definition of 'relevant financial obligations' of the FCAR and thus be covered by regula-

32 Regulation 12(3) provides that winding-up proceedings commence on the making of a winding-up order by the court and reorganisation measures commence on the appointment of an administrator, whether by a court or otherwise. This provision varies the general rule in relation to the opening of winding-up proceedings under section 129 of the Insolvency Act 1986 in terms of which these proceedings commence on the filing of a petition order.

33 Regulation 12(2) of the FCAR.

tion 12(1) of the FCAR. However, if the solvent party had notice, or should have notice, of the insolvency of its counterparty then it is expected that the transaction would be excluded from regulation 12(1) on account of regulation 12(2) of the FCAR.[34]

Finally, in order to enforce the recognition of close-out netting provisions, regulation 10(1)(b) specifically provides that Section 127 of the Insolvency Act on avoidance of property dispositions shall not apply to prevent a close-out netting provision taking effect in accordance with its terms.[35] Section 127 provides that any disposition of the company's property or transfer of shares which is made after the commencement of winding-up is void, unless the court orders otherwise. Hence, this provision makes any disposal invalid on the sole basis that it is made in a prescribed period prior to the court's order to wind up the company.[36]

4.2 Constitutive Elements of Insolvency Close-out Netting

One common approach typically adopted as a means to examine the constitutive elements of a legal concept is to analyse any applicable statutory definitions.[37] The best starting point to discern the constitutive elements of close-out netting under English law is arguably the close-out netting definition and provisions of the FCAR. The FCAR define a 'close-out netting provision' in regulation 3(1). In terms of this definition, the following elements are encompassed in the concept of close-out netting:

(a) it arises from a contractual or statutory provision,
(b) if contractual, it is related, at least in part, to a financial collateral arrangement,
(c) the provision is triggered by an enforcement event,
(d) there are two types of extinguishment of obligations, namely by acceleration of maturities or by termination,
(e) the calculation of the value of the obligation is based either on the original obligation's estimated current value or its replacement cost,
(f) setting off or netting the amounts due under the valued obligations by each party, followed by payment of the net balance.

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34 FAWCETT (2005) 296.

35 Regulation 10(1)(b) of the FCAR.

36 According to the FCAR consultation document, this safeguard was required to implement Article 8(1)(b) of the EU Directive since section 127 of the Insolvency Act applies *ipso facto.* See HM TREASURY 2003 FCAR Consultation Document, para 5.12.

37 Although the regulation of netting in payment systems is outside the scope of this research, it may be remarked that the first statutory definition of netting was provided in regulation 2(1) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999, S.I. 1999/2979, intended to implement the provisions of the EU Settlement Finality Directive. The definition of netting under these Regulations relates to settlement netting and serves the functionalities of the settlement of payments in a payment system.

These elements are also comprised in the definition of the same term found in Article 2(1)(n) of the EU Financial Collateral Directive, except for the reference to 'replacement cost' which has been added in regulation 3(1) of the FCAR in order to provide for the market valuation mechanism of certain derivatives transactions following a close-out under certain master agreements such as the ISDA Master Agreement.[38] According to Yeowart *et al.*, this definition of close-out netting envisages two ways in which close-out netting can take place, namely 'by accelerating the obligations, valuing them and setting off the obligations of each party to the other' to achieve a close-out amount, termed the 'set-off approach', or 'by terminating the obligations and replacing them with new obligations with the close-out amount being determined by reference to the market valuation of the terminated transactions', termed the 'conditional novation approach'.[39]

As a preliminary remark, it may be said that the definition of close-out netting under the FCAR is a functional definition which includes the procedural steps of the close-out process which a market practitioner is accustomed to follow in a financial collateral arrangement.[40] In order to fall within the scope of the FCAR, the close-out netting clause has to be a term of a financial collateral arrangement or of an arrangement of which a financial collateral arrangement forms part. *Prima facie,* the provisions of the FCAR therefore only apply to close-out netting provisions governed by collateralised debt obligations, not to unsecured obligations, and they are limited to those associated with financial collateral arrangements. The definition, however, also refers to a close-out netting provision being a legislative close-out netting provision. Yeowart *et al.* note that the FCD also refers to 'any statutory rule' in its Article 2(1)(n) definition. However, whilst under the FCD a statutory rule can be a close-out netting provision only 'in the absence of' a contractual provision dealing with close-out netting, under the FCAR the statutory rule may exist in parallel with the contractual provision in particular when taking into account the mandatory provisions of insolvency set-off.[41]

Doubts were expressed in Chapter 3.3.1.1 whether the FCD definition of a close-out netting provision covers cross-product netting. Ho notes that it is possible that a bilateral cross-product netting agreement may fall within the

38 See *Response of the United Kingdom to the Commission Questionnaire to Member States for the drafting of the Evaluation Report* (January 2006) at para 2.1(n). See also Section 6(e)(1) of the 2002 ISDA Master Agreement on the calculation of a close-out amount, analysed in Chapter 1.3.1.

39 YEOWART *et al.* (2016) 223 & 446.

40 It will be seen in part 2.1 below that the FCAR definition does not encompass the full range of close-out netting possibilities under English law, which also recognises close-out netting provisions outside of a financial collateral arrangement under equity and common law. See EUROPEAN COMMISSION 2006 FCD Evaluation Report, at para 4.4.

41 YEOWART *et al.* (2016) 224. The relationship between the close-out netting and insolvency set-off regimes is analysed in part 2.1 of this chapter.

definition of a close-out netting provision of the FCAR whereby an event of default under one master agreement will trigger an event of default under another or more master agreements concluded between the same parties, each of which may be defined as a financial collateral arrangement in terms of the FCAR, and the close-out amounts due under each master agreement will be netted out to produce a single net amount.[42]

The structural definition of a close-out netting provision found in the FCAR is in sharp contrast with the more generic definition of 'netting arrangements' found in section 48(1)(d) of the Banking Act 2009 and repeated in section 48P. In terms of this latter definition, netting arrangements are said to consist of 'arrangements under which a number of claims or obligations can be converted into a net claim or obligation' and which includes 'in particular, "close-out" netting arrangements under which actual or theoretical debts[43] are calculated during the course of a contract for the purpose of enabling them to be set off against each other or to be converted into a net debt'. The definition in the Banking Act is worded in generic terms as it is meant to cover various netting arrangements whether arising under the FCAR or under other sources and is therefore not restricted to a financial collateral arrangement.

This is admittedly not a very precise definition of the concept of close-out netting since its purpose is not the specific regulation of close-out netting. It does refer to some elements of close-out netting, such as the calculation of debts during the course of a contract and the determination of a net amount. However, it does not refer to any method of calculation nor to the fact that termination or acceleration should be affected. This definition only provides minimalistic features of close-out netting to ensure that the definition is not limited in any way since the legislator probably intended to capture the widest range of close-out netting arrangements. In fact, it may be interesting to note that whilst the Banking Act definition does not refer to the occurrence of a termination event which triggers the closing out of the netting arrangement, it refers instead to the conversion into a net debt of actual or theoretical debts calculated 'in the course of a contract'. This latter wording implies that the contract is still effective and has not been terminated, which thus enables the resolution authority to take the necessary measures of either bailing in the contractual obligations or transferring

42 HO (2012) 353. Ho, however, does not think that the definition is wide enough to cover multi-party netting, where the claims and crossclaims are not mutual since the definition and the provisions of the FCAR regulate the bilateral relations of the collateral-taker and collateral-provider. The element of mutuality will be analysed later in this chapter. *Ibid.* 354.

43 The reference to 'theoretical debts' is possibly to derivatives based on nominal values which involves the setting off of the values of those debts against each other or their conversion into a net debt.

them to another entity.[44] This is reminiscent of the liquidator's powers under the Insolvency Act 1986 to deal with contracts, other than financial contracts, in the best interests of the insolvent estate. It may also be noted that since the Banking Act predates the EU's BRRD, it does not reproduce the definition of close-out netting found in the latter. Nor does it refer to or link up with the definition of close-out netting provision in the FCAR though, as already seen above, it does affect the close-out netting provisions of the FCAR. This is further indicative of the intention of the legislator to include a wider range of close-out netting provisions beyond the scope of the FCAR.

It may be observed that under both the FCAR and, to a lesser extent, the Banking Act close-out netting is defined in terms of the steps or phases involved in executing a close-out netting provision, reflecting the close-out conventions of the particular markets in which it operates. It is also clear that set-off is considered by English law to be intertwined with the process of close-out netting since in the final stage both definitions refer to the set-off process for the purposes of determining a single net amount. Yeowart *et al.* confirm that the reference to set-off in the third stage of close-out netting is to contractual set-off and not insolvency set-off. Nonetheless, this implies that for close-out netting, as with set-off, the obligations should be mutually owed for the setting off of obligations to be possible under a close-out netting provision.[45]

In a rather sweeping statement Benjamin states that the key elements in the FCAR definition of close-out netting are:

> 'default; the acceleration of the time for performance of obligations to the time of default; the conversion of non-cash obligations into debts (for example, an obligation to deliver a non-cash asset is converted into the obligation to pay its market price at the time of default); and set off.'

Benjamin states that where the event of default is the insolvency of a UK company, the set-off will arguably take place in accordance with the mandatory provisions of the UK Insolvency Rules and 'the contractual provisions are drafted to track the effect of these'.[46] This statement is rather surprising since it implies that under English law a close-out netting provision will be primarily governed by mandatory set-off law, where applicable, rather than by the party autonomy principle applying under regulation 12 of the FCAR.

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44 It will be seen later in this chapter that whilst the BRRD envisages the termination of close-out netting provisions so that only net amounts are subject to the bail-in provision, under the Banking Act the bail-in provision operates on net amounts but does not impose the termination of contracts.

45 YEOWART *et al.* (2016) 448. This is confirmed in the English Law Opinion on the ISDA Master Agreements delivered by Allen & Overy LLP. See ISDA 2019 Allen & Overy 19.

46 BENJAMIN (2007) 268.

It also contradicts the number of disapplied or modified provisions made to the insolvency set-off rules in regulations 12 and 14 of the FCAR to ensure that the enforceability of close-out netting is not restricted by the insolvency set-off rules and it does not take into account the argument made earlier that the reference to set-off in the third phase of close-out netting is a reference to contractual set-off, not insolvency set-off.

The number of references made in the FCAR to the insolvency set-off rules indicates a close relationship with insolvency close-out netting. The concern about the application, or disapplication, of a number of insolvency set-off rules also stems from the fact that the latter are mandatory and self-executing. The close affinity between insolvency set-off and close-out netting is due mainly to the fact that prior to the FCAR the rules of insolvency set-off were resorted to in order to give legitimacy to the enforcement of close-out netting provisions. However, this created uncertainties of legal soundness for those close-out netting provisions which were not based on insolvency set-off rules and this may be the reason why authors like Benjamin caution on the influence of insolvency set-off rules on the operation of close-out netting provisions, at least if they do not fall under the scope of the FCAR.[47]

The situation regarding the recognition of close-out netting prior to the FCAR may be surmised from a Guidance Notice entitled 'Netting of Counterparty Exposure' issued by the Financial Law Panel[48] in 1993 to explain that the legal foundation in England for netting and set-off was considered robust. In terms of the Statement of Law made by the Panel:

> 'Where a company goes into insolvent liquidation in England and there have been mutual credits, mutual debts or other mutual dealings between the company and another party prior to liquidation, set off applies. An account must be taken of the mutual dealings and the ultimate net balance only is required to be paid to the liquidator or proved for in the liquidation.
> […]

47 This is confirmed by Yeowart *et al.* who state that prior to the FCAR, it was common practice to draft close-out netting provisions in a way which matches the results achieved by insolvency set-off. See YEOWART *et al.* (2016) 228.

48 The Financial Law Panel was set up in 1992 under the auspices of the Bank of England to work with the market to reach practical solutions to legal uncertainties as they affect wholesale markets and services in the UK. The statements and reports of the Financial Law Panel are now available on the website of the Financial Markets Law Committee at <http://www.fmlc.org>.

> Where a bank and its corporate customer enter into various transactions with each other prior to the customer's insolvent liquidation and the customer goes into liquidation before the transactions are closed mandatory set off applies. The bank will have a claim (or obligation) on a net basis only to receive from (or pay to) the liquidator the net amount in respect of the transactions taken as a whole.'[49]

This statement seems to suggest that if a close-out netting provision regards mutual obligations arising prior to the liquidation and the other party becomes insolvent before the transactions are closed, then mandatory set-off will apply and only the net amount is payable. It is not clear if the Financial Law Panel is referring to all three phases of close-out netting, *i.e.* termination, calculation and determination of a single net amount, which are regulated by mandatory set-off rules or only the third phase of determining a single net amount. It is also not clear whether the contractual enhancement features of close-out netting which go beyond the provisions of insolvency set-off rules are also protected or whether these contractual enhancements could, prior to the enactment of the FCAR, be held invalid by the courts as a means of contracting out of the insolvency rules.[50]

A better understanding of the implications of this statement and of the impact brought about by the FCAR on the recognition of close-out netting provisions may be obtained by undertaking a comparative analysis of the concepts of insolvency set-off and insolvency close-out netting and their

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49 FINANCIAL LAW PANEL 1993 Netting Guidance Notice, Schedule 1 – Statement of Law. The Statement lists a number of assumptions amongst which is that the transactions referred to consist of contracts for forward and spot foreign exchange, cross-currency and interest rate swaps, currency and interest rate options (including caps, floors and collars), forward rate agreements and similar commodity and equity-related derivatives, as well as loans by and deposits with a bank. According to McCormick, this statement was issued by the Financial Law Panel to address uncertainty in the market following some court judgments at the time about the enforceability of set-off and netting provisions especially upon the insolvency of one of the parties. See McCORMICK (2010) 234. This position is confirmed in the FCAR consultation document which states that:

> '[a]lthough there are no provisions of the Insolvency Act which we consider it necessary to disapply from financial collateral arrangements in order to give effect to Article 7(1) [of the EU Financial Collateral Directive], draft regulation 13 includes an express provision that close-out netting provisions are to take effect in accordance with their terms'. The reason given for this is 'to deal with any doubts there may be about the effectiveness of such terms when a company becomes insolvent due to common law or equitable principles […].'

HM TREASURY 2003 FCAR Consultation Document, para 5.9.

50 See GULLIFER (2017) 386. See, for instance, *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 2 All E.R. 390 regarding an arrangement between airlines for the multilateral settlement of payments on a net basis. The court held that the contractual provision for multilateral set-off was ineffective in the insolvency of a party since it was deemed as contracting out of the provisions of section 302 of the Companies Act 1948 for the payment of unsecured debt *pari passu*.

applicable regulation. This will be achieved in the succeeding part by first analysing the concept of insolvency set-off under English law and then comparing its features with those of the close-out netting technique in order to determine and assess the contractual enhancements of the latter. The discussion whether close-out netting is to be considered as a stand-alone concept will be conducted in Part III. The analysis of insolvency set-off in this chapter will focus on aspects which are considered more relevant to the research question.

4.2.1 Insolvency Set-off under English Law

The principal rule on insolvency set-off is found in rule 14.25 of the Insolvency Rules 2016[51] which in essence provides that where, before a company goes into liquidation:

> 'there have been mutual dealings between the company and a creditor of the company … an account shall be taken of what is due from the company and the creditor to each other in respect of the mutual dealings and the sums due from one must be set off against the sums due from the other.'

The right of set-off may therefore be exercised where an insolvent debtor and a creditor have had pre-insolvency mutual dealings giving rise to cross-demands. Without this right the creditor would be obliged to pay the full amount of his debt to the liquidator and would be constrained to proving with other creditors for the amount owed to it by the insolvent party. But if the requirements of rule 14.25 are fulfilled, only the balance remaining after deducting one claim from the other is payable. Insolvency set-off applies in relation to any type of obligation whether arising by virtue of an agreement or the law or otherwise. It applies to individuals and companies in relation to both liquidation and administration once the administrator has issued a notice of a proposed distribution.[52] For the purposes of this research, the focus will be on rule 14.25 of the Insolvency Rules 2016 since any substantive aspects of the insolvency set-off right under rule 14.25 also apply under other insolvency set-off provisions.

51 For the different types of set-off under English law, see GULLIFER (2017) 305; WOOD (2007) 5; DERHAM (2010) 247; YEOWART *et al.* (2016) 601.

52 Thus, similar set-off rules apply under section 323 of the Insolvency Act 1986 in relation to bankruptcy proceedings of individuals, rule 14.24 of the Insolvency Rules 2016 in relation to administration proceedings, rule 72 of the Bank Insolvency (England and Wales) Rules 2009 (S.I. 2009/356) and rules 58 to 60 of the Bank Administration (England and Wales) Rules 2009 (S.I. 2009/357) , but with some changes to reflect the different procedures.

Conceptual Issues

Insolvency set-off is primarily considered a substantive right, rather than procedural, since it affects the substantive rights of the parties by enabling the solvent creditor to use its indebtedness to the insolvent party as a form of security.[53] Any type of debt may be subject to insolvency set-off provided it is provable in the insolvency proceedings.[54] Debts owing to the insolvent party should be legally enforceable to enable the insolvency practitioner to claim it. Set-off is not confined to consensual dealings but covers also the imposition of a statutory obligation analogous to a guarantee and even the commission of a tort related to a business dealing.[55] There are, however, doubts whether secured debt is subject to mandatory set-off as will be explained below.

The basic principles regulating insolvency set-off based on an interpretation of the former rule 4.90 of the Insolvency Rules 1986, now replaced by rule 14.25 cited above, were announced by Lord Hoffmann in *MS Fashions Ltd v Bank of Credit and Commerce International SA (No.2)* (*BCCI No 2*)[56] and further elaborated in *Stein v Blake*.[57] The first of these is the *mandatory principle* which provides that if there have been mutual dealings before the winding-up order which have given rise to cross claims, neither party can provide or sue for his full claim.[58] An account must be taken and he must prove or sue for the balance. The second is the *retroactivity principle* in which the account is taken at the date of the winding-up order in the sense that the liquidation and distribution of assets of the insolvent company are treated as notionally taking place simultaneously on the date of the winding-up order. The third is the *hindsight principle* in terms of which in taking the account the court has regard to events which have occurred since the date of the winding-up. This affects also the valuation of claims and the taking of accounts.[59]

Complementary to the mandatory nature of insolvency set-off, it is also stated to be self-executing in the sense that there is no need for intervention of the parties for insolvency set-off to be executed. This self-executing nature of insolvency set-off has been put into doubt by a number of judg-

53 See GULLIFER (2017) 306; BENJAMIN (2007) 281. Issues regarding the justification of set-off will be discussed in Chapter 8.

54 See WOOD (2007) 32 for a list of common unprovable debts such as time-barred debts.

55 See VAN ZWIETEN (2018) 372.

56 [1993] 3 All E.R. 769.

57 [1996] 1 A.C. 243.

58 In *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] A.C. 785 the reason given for the mandatory nature of set-off is that it is a matter of public interest in the orderly administration of the estate and not purely a source of private rights enacted for the benefit of individual debtors.

59 These principles are now clarified in the law by the Insolvency (Amendment) Rules 2005 (S.I. 2005/527) and reflected in rule14.25 of the Insolvency Rules 2016.

ments[60] of the English courts concerning the position of secured creditors and the interference of insolvency set-off with the enforcement of security. These judgments are mainly based on the interpretation of rules 14.24(6) and 14.25(1) of the Insolvency Rules 2016 which provide that insolvency set-off applies between a company and a 'creditor of the company proving or claiming to prove for a debt in liquidation'. If the interpretation to be given to this provision is that insolvency set-off only applies to debts owed by an insolvent if such debts are proved for, then this would imply that unless the secured creditor elects to surrender the security and to prove as an unsecured creditor, insolvency set-off would not apply to the secured amount. Although as already stated, there are conflicting judgments in this respect, such an interpretation would greatly indent the self-executing nature of insolvency set-off and would render it dependent on the will of the claiming creditor.

Before examining the basic requirements for insolvency set-off, an important distinction is made by English writers between executed and executory contracts in relation to insolvency set-off.[61] An executed contract is one which has been wholly performed by one party, leaving outstanding only the unperformed obligations of the other party, such as the repayment of a loan or withdrawal of a deposit. An executory contract is one in which obligations remain to be performed on both sides and the failure of either to complete performance would constitute a material breach, such as contracts for the exchange or delivery of money, including foreign exchange contracts or interest rate swaps. Van Zwieten opines that where all of the relevant contracts are executed and the claims on both sides are for money or are reducible to money, insolvency set-off will rarely be a problem since set-off in relation to existing liquidated claims, even if payable in the future, is straightforward.[62] Executory contracts, on the other hand, may involve the acceleration of obligations or the conversion of delivery obligations into monetary obligations or the conversion of foreign currency using methods not foreseen by the insolvency set-off rules. These are some of the features which have led to the contractual enhancement of set-off through close-out netting provisions to overcome the limitations set by insolvency set-off rules. In order to better understand these contractual enhancements, it is proposed to mention briefly the basic requirements of insolvency set-off and then compare them with those of close-out netting in part 4.2.2 below.

60 For a debate on the conflicting judgments of the English courts in relation to the enforcement of security and the self-executing nature of insolvency set-off, see JAMES & KARAINDROU (2019) 228. See also McCRACKEN (2010). McCracken is of the view that since a secured creditor generally does not prove in insolvency, it should not be obliged to do so within the scope of the set-off provision. *Ibid.* 292.

61 See VAN ZWIETEN (2018) 384; WOOD (2007) 16. Wood refers to executed contracts as 'debts'.

62 VAN ZWIETEN (2018) 384.

Basic Requirements

Only rights and obligations which arise from mutual debts or mutual dealings may be the subject of a set-off, meaning that the respective claims should be owed between the same parties and these parties must be acting in the same capacity.[63] Thus, mutuality does not exist where one of the parties acts as agent for another and the counterparty attempts to set off an obligation with an obligation due by the agent in its personal capacity. In such circumstances, the set-off will be operable only against the underlying principal. It is not necessary that the claims should have arisen out of dealings between the parties if there are mutual debts. This would be the case if one of the debts which is subject to a proposed set-off has been acquired by the party asserting it in a set-off by way of an assignment from a third person[64] and by way of guarantee.[65] The techniques of assignment and cross-guarantees may also be used to manage risk exposure of affiliates belonging to the same group of companies.[66]

There is also a timing requirement. For set-off to be available in a winding-up, the relevant transaction must have been entered into prior to the commencement of the winding-up. This requirement extends only to a debt which is owing but not presently payable.[67] In addition, rule 14.25(6) of the Insolvency Rules 2016 provides that the claims that may be taken into account for set-off purposes do not include any debt that was incurred or acquired at a time when the creditor had notice of an impending insolvency or the commencement of insolvency proceedings or arises out of an obligation incurred during an administration which immediately preceded the liquidation.

For set-off to apply 'the sums due from one [party] must be set off against the sums due from the other'.[68] This implies that the claims in question must be monetary in nature, *i.e.* they must result in a liability to pay money. It is thus not possible to set off a claim for physical settlement such as the delivery of goods against a debt or an obligation to deliver identical

63 Multilateral set-off is therefore not permitted by rule 14.25 of the Insolvency Rules 2016. See ANNETTS & MURRAY (2012) 275.

64 DERHAM (2010) 284; Richard Tredgett, 'Chapter 12: England', in JOHNSTON *et al.* (2018), para 12.27 *et seq*

65 In *BCCI No 2* [1993] 3 All E.R. 769 Hoffman L.J. was prepared to give a wide interpretation to the mutuality arising by guarantee and held that even if the guarantor was not called upon to pay under the mortgage so that his liability remained contingent, however the wording of the mortgage-related documents was considered sufficient to create a liability vis-à-vis the guarantor.

66 WOOD (2007) 96 & 101.

67 In *Re Nortel Companies* [2013] UKSC 52 the court confirmed that a contingent debt arising out of a pre-existing contractual obligation qualifies as a claim under insolvency set-off.

68 Rule 14.25(2) of the Insolvency Rules 2016.

goods.[69] This limitation does not extend to obligations to deliver a foreign currency under a foreign exchange contract (which could be considered as a commodity bought and sold) since rule 14.21 of the Insolvency Rules 2016 provides a mechanism for converting the foreign debt into sterling.

It is no obstacle to the availability of set-off on a winding-up or administration that an obligation due to or from the company is contingent or only payable in the future.[70] In these circumstances, the liquidator must estimate its value and use the estimated value for set-off purposes. A contingent liability may give rise to a number of difficulties, the main one being that the relevant contingency might not materialise and the creditor would therefore have to give credit for an obligation that might never mature into an actual liability. The law in fact provides that if a net sum is due from the creditor, to the extent that it consists of a contingent debt, it will not be payable unless the contingency occurs.[71] However, in computing the net sum, any claim that the creditor would otherwise have against the company will be reduced by the value that has been placed on the contingent obligation, even if it subsequently turns out that it would never have become payable.

Finally, the mandatory nature of insolvency set-off implies that it replaces other forms of set-off upon the insolvency of one of the parties. But it does not replace the contractual provisions of a close-out netting clause, at least insofar as the close-out netting provision is protected under the provisions of the FCAR. Insolvency set-off is regulated by the provisions of insolvency law and as such parties to a set-off arrangement are not considered as contracting out of the insolvency rules, otherwise their arrangement could be held invalid by the courts. Close-out netting provisions, on the other hand, have been recognised under the FCAR, and prior to that under common law and equity, where they are treated as a permitted exception to the collective procedures of insolvency law. The brief overview made above of insolvency set-off indicates that it operates as a flexible instrument for the reduction of exposure between the parties and for this reason could have served for the protection of close-out netting provisions in the years preceding the FCAR. In the part below the constitutive elements of insolvency set-off and close-out netting will be compared in order to determine the contractual enhancement aspects of close-out netting. These contractual enhancements will then be viewed in the light of public policy and state insolvency goals in part 4.4 of this chapter.

69 FIRTH (2013), para 5.008.

70 Rule 14.25(7) of the Insolvency Rules 2016. The principle that contingent claims were included in set-off was not always consistently applied by the English courts until the matter was resolved in *Secretary of State for Trade and Industry v Frid* [2004] 2 AC 506. See Richard Tredgett, 'Chapter 12: England', in JOHNSTON *et al.* (2018), para 12.20.

71 Rule 14.25(8) of the Insolvency Rules 2016.

4.2.2 Insolvency Close-out Netting and Insolvency Set-off Compared

It may be difficult to draw a line of demarcation between the concepts of insolvency close-out netting and insolvency set-off given that insolvency set-off is widely applied and interpreted under English law. The close relationship between the two concepts is evident in opinions expressed by authors even though these opinions may at times vary on the extent of this relationship. Thus, Hudson makes the statement that 'close-out netting is dependent on the general law on insolvency set-off' which, although rather ambiguously worded, may imply that where the conditions of insolvency set-off are satisfied, the close-out netting provisions will be regulated by insolvency set-off rules and not the FCAR.[72] Firth, on the other hand, whilst acknowledging that close-out netting is often spoken of 'as an application of the law of set-off', if no set-off is involved, then an agreement should not be struck down on the basis that it does not satisfy the requirement for set-off to be available.[73] Henderson takes the discussion a step further and notes that close-out netting is not set-off since it is the valuation of a whole agreement and is not the consideration of the value of a liability against another, even though he admits that courts might analogise close-out netting to set-off, based on considerations of public policy.[74]

A comparison between the concepts of insolvency set-off and close-out netting may lead to a better appreciation of the relationship between these two concepts. Under English law this relationship is rather critical since once the conditions of insolvency set-off materialise, insolvency set-off rules will have to be adhered to for close-out netting to be effective. The comparison of the various features of the two concepts will also help determine the contractual enhancement aspects of close-out netting as recognised under the FCAR which distinguish it from insolvency set-off. First the scope of application will be considered, followed by a comparison of the basic requirements and other features.

Scope of application

Both the insolvency set-off rules and the FCAR provisions have a wide material scope of application. Neither of these regimes depend on the transactions being of the same kind. However, whilst there appears to be no limitation to the type of obligations that may be set off provided these are provable in an insolvency, the FCAR only contemplates the close out of 'relevant financial obligations' applicable in relation to financial collateral

72 HUDSON (2018) 17-58.

73 Set-off would be involved where, for instance, payments that were unconditionally due to be made prior to termination of a close-out netting arrangement are taken into account in calculating the close-out amount as they may be considered to constitute separately enforceable debts. See FIRTH (2013), para 5.067.

74 HENDERSON (2010) 481.

arrangements.[75] The FCAR definitions do not as such limit the type of obligation but it is understood that this must be an obligation which could be the subject of a financial collateral arrangement. Thus, it would exclude obligations under tort or damages which may be considered under set-off. The question arises whether obligations beyond the remit of the FCAR may be considered for the purposes of insolvency close-out netting. The FCAR consultation document declares that there are no restrictions under English law to prevent the enforcement of close-out netting provisions in accordance with their terms[76] so that the limitation to 'relevant financial obligations' may arise solely as a consequence of the fact that the FCAR implements the EU's Financial Collateral Directive. This appears to be also contemplated by the definition of 'netting arrangements' in the Banking Act which refers generally to 'claims or obligations'. However, the definition of the Banking Act is arguably intended to serve for reference purposes and is not meant to regulate the parameters of the concept of close-out netting.

The personal scope of both concepts is also widely construed. Thus, insolvency set-off applies to individuals and corporates, whilst close-out netting under the FCAR applies to non-natural persons. As already seen in part 4.1 of this chapter, the FCAR consultation document states that close-out netting under English law may also be availed of by individuals, however since the FCAR has been issued under enabling powers of section 2(2) the European Communities Act 1972, it did not appear appropriate to extend the FCAR to individuals. Hence, there is rather a technical, and not a substantive, reason why the FCAR provisions have not been extended to individuals, though the legislator presumes that close-out netting provisions entered into by individuals are also protected under English law, presumably if they comply with the provisions of insolvency set-off.[77]

Basic Requirements

First, mutuality is a requirement which must be satisfied for both insolvency set-off and close-out netting to be available. There is nothing in the provisions of the FCAR which requires that there are mutual debts between the parties to a close-out netting provision, as is required by rule 14.25 of the Insolvency Rules 2016. Fawcett, whilst noting that the FCAR are silent about the requirement of mutuality in close-out netting, notes that it would be against public policy in England to exclude mutuality and if the legis-

75 See the definition of 'close-out netting provision' in combination with the definitions of 'financial collateral arrangement', 'title transfer financial collateral arrangement' and 'security financial collateral arrangement' in Article 3 of the FCAR.

76 HM TREASURY 2003 FCAR Consultation Document, paras 1.12 & 5.9.

77 This presumption is supported by the statement made by the English legislator in the FCAR consultation document that, in relation to the implementation of Article 7(1) of the EU Financial Collateral Directive, rule 4.90 (now rule 14.25 of the Insolvency Rules 2016) continues to apply to financial collateral arrangements. HM TREASURY 2003 FCAR Consultation Document, para 5.9.

lator had intended to exclude mutuality then the intention would have been more clearly stated.[78] Hudson opines that there must still be mutual debts under the FCAR since for there to be a financial collateral arrangement, there must be some provision of cash or securities to cover the relevant financial obligations owed to the secured party by the debtor.[79] The same argument is made by Gullifer who states that the FCAR addresses 'parties' to a financial collateral arrangement and is intended to implement the FCD which refers to bilateral close-out netting provisions in its recital (14).[80] An important distinction is made by Firth in the fulfilment of the mutuality requirement between insolvency set-off and close-out netting. Firth states that mutuality may become problematic in insolvency set-off where the insolvent company has physical settlement obligations which the liquidator elects to perform, since it does so in a new interest and a new capacity, so that any mutuality is destroyed and the transaction cannot therefore be brought into account. However, according to Firth, if in a close-out netting arrangement there is a so-called 'flawed asset' provision, implying that if the solvent company is in default the other party can refuse to perform and a close-out takes place, a net exposure should be achieved even if the set-off arrangements are unenforceable.[81] The fulfilment of the mutuality requirement may be problematic in inter-group or multilateral arrangements for both concepts. As mentioned in part 4.2.1 of this chapter, inter-group set-off and netting is ineffective on the insolvency of one of the companies since the claims would not be mutual, unless mutuality is created by each company guaranteeing the others' claims. This would be analogous to the situation in *Re BCCI No 2*. In the same vein, the type of bilateral netting provisions recognised under the FCAR does not contemplate a multilateral type of netting of the sort contemplated by the *British Eagle* case.[82]

Second, under both set-off and close-out netting, obligations must be of a monetary nature. Whilst in set-off a stricter interpretation is applied in the sense that non-monetary obligations, such as delivery obligations, may only be considered if they can be given a monetary value,[83] in close-out

78 FAWCETT (2005) 296.

79 HUDSON (2013) 1250.

80 GULLIFER (2017) 386.

81 FIRTH (2013), paras 5.011 & 5.060. The same argument has been resorted to by van Zwieten in the discussion on executed and executory contracts made in part 4.2.1 when stating that obligations under executory contracts cannot be set off since the unperformed contract is taken over by the liquidator and hence mutuality no longer exists.

82 However, recognition of multilateral netting schemes regarding investment exchanges and clearing houses has been granted under the Financial Services and Markets Act 2000 and the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (S.I. 1999/2979). In these instances, the novation of transactions forms the basis of many multilateral netting arrangements, whereby transactions entered into between the members of a clearing system to a central clearing house are novated in order to create mutuality between each party's rights and obligations. See FIRTH (2013), para 5.035.

83 This is in accordance with rule 14.25(2) which provides, *inter alia,* that 'sums due from one [party] must be set off against the sums due from the other'.

netting no such restriction applies so long as the close-out netting arrangement provides a method to terminate any outstanding delivery or other settlement obligations and replace them with an obligation to pay a sum of money. According to Firth this would be the case regardless of whether the delivery obligations were due to have been performed before or after the termination date as long as on insolvency an obligation to pay a cash sum arises in their place.[84] In addition, both the insolvency set-off and close-out netting regimes foresee a liberal conversion of foreign currency. Whilst rule 14.21(2) of the Insolvency Rules 2016 requires the conversion of all debts into sterling at a single rate for each currency determined by reference to the exchange rates prevailing on the relevant date, regulation 14 of the FCAR does not impose the conversion of the monetary value of the debt into sterling and permits the exchange rate mechanism foreseen for the conversion of foreign currency in the netting agreement provided this is not an unreasonable exchange rate.

Third, it has been seen that in relation to insolvency set-off, rule 14.25(8) of the Insolvency Rules 2016 contains a mechanism for valuing contingent debts and requires that any future obligations be discounted at a prescribed rate. If the contingent debt cannot be estimated by the set-off rules, its value may be estimated. This valuation may be subject to revision if considered inaccurate. Close-out netting agreements seek to circumvent these requirements by converting any contingent or future obligations into a present obligation, through termination or acceleration of its maturity, to pay the net sum calculated in accordance with the valuation terms of the agreement.[85] It is typically the case that the valuation is done by the solvent party, designated as the 'non-defaulting party' in the applicable master agreement. The close-out netting valuation process also permits taking into account certain costs which would not normally be considered in the valuation of contingent debts in set-off, such as losses relating to the hedging of transactions.[86]

Fourth, in part 4.2.1 it is stated that set-off only applies in respect of executed contracts, whilst close-out netting may apply in respect of executory contracts since it involves the termination or acceleration of obligations of both parties.[87] Thus, whilst the insolvency set-off rules foresee the possibility of valuing contingent and future debts which become fully effective once these debts mature, it does not provide for the possibility of the parties

84 FIRTH (2013), para 5.069.

85 In terms of the ISDA English Law Opinion, 'To include contingent debts within the scope of close-out netting it is simply necessary to provide a method for valuing such debts.' *Ibid.* p 25.

86 The reason for this distinction may actually be more practical than academic since hedging is more typically associated with executory, rather than executed, contracts. Moreover, Hudson sheds some doubts on the readiness of the courts to accept the inclusion of hedging costs in the close-out netting valuation and recommends that their acceptance may be better guaranteed if their calculation methodology is specified in the master agreement. HUDSON (2018) 17-65.

87 For a list of examples of executed and executory contracts, see WOOD (2007) 16.

to terminate or accelerate outstanding transactions. Van Zwieten notes that where contracts on both sides are still executory at the time of winding up, the solvent party is exposed to the risk of cherry-picking by the liquidator, leaving the solvent party to prove in the winding up for damages.[88] The solution has been provided by the close-out netting mechanism whereby all executory contracts are automatically terminated or closed out in the event of either party going into liquidation, assisted by the application of the single agreement concept whereby all transactions between the same parties are deemed to form part of the same agreement.[89] Hudson, on the other hand, argues that the approach of the English courts has been that if the parties can put a value on the entire executory contract, then that amount can be set off. However, the case cited by Hudson to substantiate this claim[90] refers to the possibility to place a value on future, contingent obligations in credit card use, rather than on executory contracts where both parties still have to perform their obligations.[91] The issue of valuing contingent debts is, arguably, a different issue which is still considered under the purview of executed contracts and Hudson's interpretation of the situation does not take into account the cherry-picking argument made by van Zwieten but only considers whether it is possible to value the unperformed obligations.

The above comparative overview of the basic requirements and features of insolvency set-off and close-out netting indicate that the contractual enhancement features of close-out netting have served to formulate a risk-reduction mechanism which meets the requirements of the financial markets. Prior to the advent of the FCAR, the insolvency set-off rules may have been considered to be sufficiently flexible in order to accommodate close-out netting provisions under English law. This has been confirmed, amongst others, by the Statement of Law on 'Netting of Counterparty Exposure' issued by the UK Financial Law Panel in 1993 confirming the enforceability of close-out netting provisions under English law as well as the FCAR consultation document declaring that there are no restrictions under English law which need to be removed to implement Article 7 of the EU's Financial Collateral Directive in order to enforce close-out netting provisions. The FCAR consultation document also declares that it is understood that insolvency set-off rules under (the former) rule 4.90 of the Insolvency Rules 1986 will continue to apply to financial collateral arrangements.

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88 See section 178 of the Insolvency Act 1986.

89 VAN ZWIETEN (2018) 385.

90 *Re Charge Card Services* [1987] Ch 150. Hudson quotes Millett J when he states:

> 'By the turn of the [20th] century, therefore, the authorities showed that debts whose existence and amount were alike contingent at the date of the receiving order, and claims to damages for future breaches of contracts existing at that date, were capable of proof and, being capable of proof, could be set off under the section provided that they arose from mutual credits or mutual dealings. The only requirement was that they must in fact have resulted in quantified money claims by the time the claim to set off was made.'

91 HUDSON (2018) 17-103.

This may lead to the question whether English law actually distinguishes between the two concepts or whether the FCAR is merely declaratory of the existing legal regime? It could be argued that given the wide application of insolvency set-off under English law, it was deemed that there are no substantive restrictions which could hamper the enforceability of insolvency close-out netting provisions. However, this approach does not take into account, among other contractual enhancements, the important distinction made between executed and executory contracts, and the possibility to terminate outstanding transactions which is only possible under a statutory recognised close-out netting provision. Thus, notwithstanding the flexibility with which insolvency set-off rules have been operated (and indeed there are relatively few contractual enhancements under English law when compared to the other two selected regimes), termination is not foreseen in these rules so that rule 14.25 of the Insolvency Rules 2016 only permits the setting off upon insolvency of individual transactions in relation to executed contracts. Executory contracts, on the other hand, are generally intended to govern an entire business relationship between two parties or, alternatively, a series of transactions to be concluded over a relatively long duration which may be closed out prematurely on the happening of a trigger event. This type of contracts, which may include master agreements, are ideally suited to govern business relationships in certain markets, most typically the financial markets, as they render business relationships efficient, serve to reduce counterparty exposure, safeguard against unhedged open positions and, depending on the prevailing circumstances, may prevent or mitigate systemic risk. Thus, whilst it may be the case that English law may not draw a distinction in the regulation of set-off or close-out netting of obligations in relation to an executed contract where the conditions of insolvency set-off concur so that in these cases rule 14.25 of the Insolvency Rules 2016 may be construed to apply to both concepts (since this rule is mandatory and self-executing), the FCAR is arguably necessary to protect the enforceability of close-out netting in relation to executory contracts and in respect of the other contractual enhancements considered above. To the extent that the insolvency set-off conditions are not met in relation to an executed contract, there seems to be no statutory restriction why a close-out netting provision may not benefit from recognition under the FCAR if the provisions of the latter are fulfilled.

The legal situation, however, was different prior to the FCAR. Thus, in *British Eagle* the court was not prepared to give a wide interpretation to the insolvency set-off provisions to recognise the efficiency created by the executory-type of arrangement adopted by the airline operators through IATA for the settlement of their payments on a multilateral basis, since this arrangement could not be rescinded under applicable rules, the mutuality aspect was deemed missing and the arrangement was considered to amount to a contracting-out of the *pari passu* rule. In *BCCI (No 2)*, on the other hand, the courts were prepared to give a wide interpretation to the mutuality requirement in an executed-type of contract by accepting that a guarantor could be allowed to set off personal claims against the debts of the company which he guaranteed as this was deemed to be a just outcome to the situation. Thus, the development of insolvency close-out netting and its use as an instrument not only for market efficiency and for the reduction of counterparty exposure, but also to allow for the development of new financial instruments and to protect against systemic risk, may have given a new meaning to the protection of executed and executory agreements under the FCAR which might not have been originally contemplated in 2003 when these Regulations were adopted. On the other hand, close-out netting agreements not falling within the remit of the FCAR, such as those between sole traders or not related to a financial collateral arrangement, the protection of the FCAR is not available and these will need to fulfil the requirements of the insolvency set-off rules which, as seen above, are relatively more strict to satisfy and are restricted to executed agreements as technically they do not foresee the termination or acceleration of outstanding transactions.

4.3 The Recognition of Close-out Netting Provisions Before and After the Adoption of a Bank Resolution Regime

As already described in part 4.1 of this chapter, there are three important elements related to the recognition of close-out netting provisions under the FCAR. First, in regulation 12(1) it is stated that a close-out netting provision is to take effect 'in accordance with its terms' and this notwithstanding the commencement of winding-up proceedings or the taking of reorganisation measures. Regulation 12(1) of the FCAR implements the provisions of Article 7(1)(a) of the EU's FCD. The primary close-out netting rule under English law is therefore to respect contractual freedom in the applicability of close-out netting provisions even upon the institution of insolvency proceedings.

Second, under regulation 12(2) recognition is not granted to close-out netting provisions if the solvent party had actual or constructive knowledge of the insolvency or imminent insolvency of the other party. Regulation 12(2), on the other hand, is a 'home-grown' provision and has arguably been included on the basis of recital (15) of the FCD which permits the imposition of certain national law restrictions.

Third, the FCAR disapply certain provisions to ensure the enforceability of close-out netting provisions. Thus, regulation 10(1)(b) disapplies section 127 of the Insolvency Act 1986 on avoidance measures, regulation 12(4) disapplies certain (former) provisions on insolvency set-off in relation to close-out netting provisions and regulation 14 provides that the currency conversion standards of the insolvency set-off rules do not apply provided the financial collateral arrangement provides for a reasonable exchange rate. This state of affairs is rather enigmatic since it raises the question whether this implies that other provisions on insolvency set-off will therefore invariably apply. There are conflicting views on this issue[92] but the view taken in this research is that the reference made to certain provisions of the Insolvency Rules is not to be interpreted that other insolvency set-off provisions will apply to close-out netting unless, as noted above, the conditions of insolvency set-off are met prior to bringing the close-out netting provision into effect and then rule 14.25 of the Insolvency Rules 2016 becomes mandatory and self-executing. This would conform with the view of the legislator expressed in the FCAR consultation document that specific disapplications from insolvency law were only made in those cases where doubts arose as to their applicability as otherwise it was considered there were no obstacles to the enforcement of close-out netting provisions in accordance with their terms.[93]

Regulation 12 has given rise to interpretation problems on whether insolvency set-off rules may still apply in cases where insolvency set-off conditions are met, notwithstanding that the provisions of regulation 12 apply in respect to a particular close-out netting provision. Ho offers two interpretations to the configuration of regulation 12.[94] The first is that unless the situation falls within the exclusions of regulation 12(2), a close-out netting provision takes effect as a matter of contract and the statutory set-off rules have no role to play. The second interpretation, favoured by Ho, is that in the circumstances where the insolvency set-off rules apply, a close-out netting provision would always give way to the application of insolvency rules. Gullifer considers that the FCAR provisions 'support the view that insolvency set-off is displaced by the contractual scheme, and this also has the benefits of consistency with the other carve-outs'. According to Gullifer it is therefore no longer required to ensure that the close-out netting provision is formulated on the basis of insolvency set-off rules or, alternatively, that it is drafted in a way which avoids resort to set-off, such as by using novation.[95] Of a contrary view are Yeowart *et al.* who consider that regulation 12 cannot be considered as preventing the operation of insolvency set-off if, before the close-out netting provision is brought into effect, the administrator gives notice of a distribution or an order is made for winding-up.

92 Derham and Ho agree that insolvency set-off rules in general do not apply when a close-out netting arrangement is regulated by Regulation 12 of the FCAR. See DERHAM (2010) 769; HO (2012) 351. However, Firth proposes that regulation 12(4) is to be interpreted to the effect that the rest of rules 14.24 and 14.25 of the Insolvency Rules 2016 do apply to close-out netting arrangements 'so that the requirement for close-out netting provisions to take effect in accordance with their terms is intended to be subject to these rules.' See FIRTH (2013) paras 6.035 & 6.036. Of the same view are Yeowart *et al.* in YEOWART *et al.* (2016) 233.

93 HM TREASURY 2003 FCAR Consultation Document, paras 5.9, 5.12 & 5.13. The ISDA English Law Opinion also confirms that there is a remote likelihood that if close-out netting does not occur before commencement of liquidation, it would be replaced by the statutory insolvency set-off provisions. *Ibid.* 27.

94 HO (2012) 351.

95 GULLIFER (2017) 387.

Although acknowledging that this goes against the spirit of the FCD of having in place a robust close-out netting regime, they state that there is nothing in regulation 12 to disapply rules 14.24 and 14.25 of the Insolvency Rules 2016 in their entirety.[96] While the view has already been expressed above that the specific disapplication of certain provisions of insolvency law should not be taken to mean that the other provisions are deemed to apply, however considering the mandatory nature of the insolvency set-off rules it is opined that if the administrator or liquidator brings into force the insolvency rules before the trigger of a close-out netting provision, then the insolvency set-off rules will apply. This seems to be confirmed by the UK legislator in the FCAR consultation document where it is stated that 'Rule 4.90 will continue to apply to financial collateral arrangements, and there is no need for the regulations to make specific mention of this'.[97]

The regulation of close-out netting prior to the financial crisis is broadly reflected in the provisions cited above. After the financial crisis, regulation 12(5) was added to the FCAR to provide that nothing prevents the Bank of England imposing a restriction on the effect of a close-out netting provision in the exercise of resolution powers under the Banking Act.[98] It has been seen above that the definition of reorganisation measures does not include resolution measures taken under the Banking Act so that the freedom of the parties to close out an executory contract in this circumstance is not foreseen or is not enforceable under the FCAR. It would thus seem that this provision is either superfluous or seeks to establish a link between the Banking Act and the FCAR insofar as concerns their respective close-out netting provisions.[99] This is arguably the case so as to establish a hierarchy between the provisions of the FCAR and the Banking Act and to ensure that the implementation of a close-out netting provision under the FCAR does not frustrate, in any possible residual way, the implementation of resolution measures.

Resolution Measures

In its original version, the Banking Act did not contain substantive provisions on close-out netting. Of relevance to netting were two enabling provisions, namely sections 47 and 48, still in existence, which empowered the Treasury to make orders to impose restrictions on the exercise of resolution powers to make partial transfers[100] and to protect security interests, title transfer collateral arrangements and rights of set-off and netting, including

96 YEOWART *et al.* (2016) 232.

97 HM TREASURY 2003 FCAR Consultation Document, para 5.9.

98 Regulation 12(5) of the FCAR was added by the Bank Recovery and Resolution (No. 2) Order 2014/3348 Sch. 3(3) (S.I. 2014/3348).

99 This may be similar to the link established between the EU's FCD and BRRD through, for instance, Article 2(1)(98) of the BRRD.

100 Section 47 of the Banking Act 2009.

close-out netting, which might be adversely affected by a partial property transfer in respect of partial property transfers.[101] The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009[102] purports to give effect to these matters. In 2014 the Bank Recovery and Resolution Order 2014[103] brought a number of amendments to the Banking Act 2009, which, in terms of the Explanatory Note attached to this Order, were intended to 'align existing provisions with the requirements of the RRD [EU Bank Recovery and Resolution Directive] and create new powers for the Bank of England required by the RRD'. Further finetuning took place by means of the Bank Recovery and Resolution Order 2016.[104]

There are three main types of restrictions which may be imposed under the Banking Act 2009 in relation to close-out netting arrangements, namely suspension of the exercise of termination rights, exercise of the bail-in provision and transfer of assets. Since the applicability of the Banking Act is restricted to banks and certain investment firms, these restrictions do not affect other institutions or corporations whose agreements are protected by the FCAR.[105] Since the Banking Act was adopted prior to the BRRD, it will be noted below that these restrictions underwent substantial amendments to converge with the provisions of this EU Directive. The effect of each of these measures on the enforceability of close-out netting provisions under the party autonomy principle is examined below.

Suspension of Termination Rights

It has been stated above that an important contractual enhancement of the close-out netting concept is the recognition of the option of the parties to terminate executory contracts on the occurrence of a trigger event. In addition, it has also been noted that the Banking Act 2009 applies to any type of close-out netting arrangement, and not solely to those falling within the scope of the FCAR. Termination rights of netting arrangements, whether or not these are regulated by the FCAR, are affected by section 48Z of the Banking Act 2009 which provides that a crisis management measure or a crisis prevention measure as defined under the same article, is to be

101 Section 48 of the Banking Act 2009.

102 S.I. 2009/322.

103 S.I. 2014/3329.

104 S.I. 2016/1239. This Order brought, *inter alia*, finetuning amendments to section 48Z of the Banking Act 2009 on 'Termination Rights etc.'.

105 It will be recalled that close-out netting agreements concluded between corporate entities are also protected under the FCAR. These are not captured by the Banking Act 2009 but may, however, be ultimately affected by the stay of individual enforcement actions imposed under Articles 6 and 7 of the proposed Directive (EU) 2019/1023 of the European Parliament and of the council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L 172/18, since they are not excluded parties under Article 1(2) of the same Directive.

disregarded in determining whether a default event provision in an agreement applies, provided that 'the substantive obligations provided for in the contract or agreement (including payment and delivery obligations and provision of collateral) continue to be performed'. This proviso, as well as the reference to crisis management and crisis prevention measures, were lacking under the original version of this rule as appearing in former sections 22[106] and 38[107] of the Banking Act 2009 and were introduced to transpose the BRRD. The effect of this provision is that whilst termination is not possible on the basis of the taking of resolution measures, yet termination is still protected and may be enforced if the party under resolution is in breach of substantive obligations such as delivery and payment obligations and the provision of collateral.[108]

Section 70C on the suspension of termination rights has been added to the Banking Act 2009 in order to implement the BRRD. 'Termination right' is defined in section 70C(10) to refer, *inter alia*, to the right to terminate a contract and the right to accelerate, close out, set off or net obligations. A similar provision did not exist in the original version of the Act so that the legal position in relation to termination rights before the BRRD was that the law set restrictions on the exercise of termination rights in relation to specific resolution measures without subjecting these to the continued performance of obligations under the netting arrangement. Therefore, the rights of creditors under netting arrangements are more adequately protected under the current law. Similar to the position under the BRRD, section 70C imposes restrictions on termination rights which are accompanied by safeguards intended to protect the rights of the solvent party. The principal restriction is that the Bank of England may suspend the exercise of termination rights which suspension is effective upon the publication of the relevant instrument of suspension and ends no later than midnight at the end of the first business day following the day of publication of the instrument. The safeguards provided are firstly that the bank under resolution should continue to perform substantive obligations under the agreement. Second, the solvent party is able to exercise termination rights before the expiry of the suspension if given notice by the Bank of England that the

106 Dealing with transfer of securities.

107 Dealing with transfer of property. A similar provision was made in section 48M, added by section 4 of the Financial Services (Banking Reform) Act 2013, when the bail-in option was introduced.

108 Whilst the Banking Act 2009 seeks to maintain a balance between the imposition of restrictions and the provision of safeguards, Gleeson and Guynn note that the various instruments and orders that may be issued which, for instance, specify that default event provisions are to be disapplied are significant since they could alter the contractual expectations of the parties. They state that these disapplication powers have changed attitudes about the effectiveness of early termination and close-out netting provisions under English law where one of the parties is a bank and this is being noted by English lawyers when providing legal opinions on agreements such as the ISDA master agreement. See GLEESON & GUYNN (2016) 264.

contract will not be transferred or will be subject to a mandatory reduction instrument or a resolution instrument. Third, termination rights may be exercised after the suspension if triggered otherwise than through the exercise of a stabilisation power or the imposition of a suspension. Finally, in order to ensure due observance of systemic risk, the Bank of England is to have regard to the impact which a suspension might have on the orderly functioning of the financial markets.

Partial Transfers

A partial property transfer exercised in relation to a netting contract disrupts both the single agreement concept and also the close-out netting mechanism since it splits up the various transactions covered by the close-out netting provision. In order to prevent this, special protection is afforded to, amongst other interests, netting arrangements. The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the 2009 Order) imposes an obligation on the Bank of England to transfer complete netting packages. The 2009 Order applies in respect of netting arrangements as defined in section 48(1) of the Banking Act and, for the avoidance of doubt, article 1(4) provides that the reference to netting arrangements covers also netting arrangements under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and close-out netting provisions under the FCAR. The prohibition of a partial property transfer is extended to netting arrangements concluded between a person and a banking institution. This may therefore include individuals who, as seen above, are excluded from the scope of the FCAR. The rationale behind this is arguably that the 2009 Order intends to protect any netting arrangement concluded with a bank and not solely those falling within the scope of the FCAR.[109] Further safeguards are provided in article 3(2) whereby a partial property transfer may not include provision under the continuity powers[110] which terminates or modifies the protected rights or liabilities between the parties to a netting arrangement, whilst under article 3(3) rights and liabilities are protected in so far as they are not excluded rights and liabilities in terms of article 1(3) of the 2009 Order. The end result of this exclusion is that this may disrupt certain master netting arrangements which include cross-product netting where one of the amounts to be netted is an excluded right or liability but otherwise keeps intact the close-out netting of those liabilities which are included in the protection against

109 The consequence of this is that a netting arrangement where one of the parties is an individual will then be subject to the rules on insolvency set-off for its validity. This may leave room for doubt about the protection of rights and liabilities arising out of these netting arrangements concluded by an individual with regard to executory contracts since they are protected by neither the FCAR nor rule 14.25 of the Insolvency Rules 2016, with the result that they may be considered as an invalid means of contracting out of the insolvency rules.

110 Continuity powers are defined under section 64(2) of the Banking Act 2009.

partial transfers.[111] Concerns were also allayed that the resolution authority would be able to 'cherry pick' which assets and liabilities to transfer, thus leading to arbitrary and unfair results.[112]

Bail-in Provision

In terms of section 48B of the Banking Act and the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 (the 2014 Order), the Bank of England may bail in certain liabilities relating to derivatives, financial contracts and qualifying master agreements.[113] The exercise of bail-in powers may lead to the cancellation or modification of a liability of a bank under resolution or of a contract in relation to that liability.[114] Since derivatives, financial contracts and qualifying master agreements benefit from greater protection in insolvency due to set-off and netting rights related to them, these are respected under bail-in, thus ensuring that creditors are not treated worse than they would have been in insolvency.[115] Therefore, where a protected liability in terms of this Order relates to a derivative, financial contract or a qualifying master agreement, it must be converted into a net debt, claim or obligation before it can be bailed in.[116] In terms of article 4(6), the conversion into a net amount may be done either in accordance with the provisions of the relevant netting arrangement or by an estimate of the net

111 As confirmed in the ISDA English Law Opinion, the prohibition also covers secured transactions so that a secured asset may not be separated from the liability it secures under a partial transfer. *Ibid.* p 110.

112 YEOWART *et al.* (2016) 111.

113 All terms are defined in article 5 of the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014. Connelly criticises the way the legislator has defined certain terms with the result that certain mismatches in the definitions under the 2014 Order from those of the BRRD and the FCAR have left some types of arrangements uncovered by this Order. In brief, Connelly notes that the definition of 'derivative' refers to Article 2(5) of *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories*, [2012] OJ L 201/1 and seems to exclude from the protection of article 4(1) spot transactions such as foreign exchange spot transactions. Connelly also criticises the fact that the definition of netting arrangements refers to the definition given in section 48P(2) of the Banking Act which ignores the existing English law definitions such as those found in the FCAR. Although Connelly admits that section 48P(2) may be given a purposive interpretation, it is not as wide as the FCAR interpretation which covers the three types of netting typically used to close out transactions under the market standard master agreements, namely acceleration of obligations, termination and taking account of all sums due, with the creation of an obligation to pay a sum equal to the net sums due. See CONNELLY (2015) 81.

114 Section 48B(1) of the Banking Act 2009.

115 HM TREASURY 2017 SRR Code of Conduct, para 8.27.

116 It is noted in the ISDA English Law Opinion that unsecured liabilities are not protected in terms of article 4(3) of the 2014 Order. It is therefore recommended that an ISDA Credit Support Document is entered into to ensure protection of the close-out netting mechanism. *Ibid.* 117. This understanding is in line with the protection given solely by the FCAR to close-out netting provisions which form part of a collateral financial arrangement or are related to it.

amount by the Bank of England in the special bail-in provision. This power could be used to convert the right into a net debt. Following this conversion, the net claim can be bailed in in the same way as the bank's other liabilities. According to the Banking Act code of practice, '[t]hese contracts need not be closed out prior to bail-in, or treated as if they had been closed out […] they remain protected by the "No shareholder or creditor worse off" safeguard which will take into account any set-off or netting rights that would have been respected in insolvency'.[117] The special bail-in provision therefore does not foresee the close-out of netting arrangements but solely the determination of a net amount in order to ensure observance of the no creditor worse-off principle. This implies that the contracts continue in existence but the bail-in may affect the actual amount which the solvent counterparty may recoup.

4.4 Rationale of English Insolvency Law

It has been stated in part 4.1 that as a common law jurisdiction English law considers favourably pre-insolvency contractual entitlements. Close-out netting, similar to insolvency set-off, may be considered as a type of such contractual entitlement which is recognised as effective upon the insolvency of a counterparty. Notwithstanding this recognition, close-out netting remains an exception to the collective nature of English insolvency law and, in particular, an exception to the *pari passu* principle. The interaction of the recognition of close-out netting rights with the rationale of English insolvency law will be considered in this part.

Fletcher states that English insolvency law pertains to those systems of insolvency administration which offer a collective approach whereby a uniform method is applied in the final administration and distribution of the debtor's property to calculate the abatement which will be experienced by all claims of unpaid creditors who are ranked in common together under the *pari passu* principle. Fletcher further states that English insolvency law embodies a number of value judgments about the relative priority of the various kinds of liabilities owed by an insolvent debtor, and of the order in which these groups of liabilities should be discharged out of the limited funds available for the purpose. However, there is no equality among creditors under English law so that defined groups of creditors are accorded preferential status or enjoy some kind of privilege. These creditors enjoy improved prospects of repayment by comparison with the general body of creditors.[118]

117 HM TREASURY 2017 SRR Code of Conduct, para 8.32. Gleeson and Guynn state that the protection of article 4 of the 2014 Order 'is only available prior to the agreement's being closed out – when the claim arising under the agreement has been converted into a net debt, that claim may be bailed in. Such conversion may be effected by the resolution instrument itself, but it remains the case that netting under un-closed-out masters will be respected.' GLEESON & GUYNN (2016) 309.

118 FLETCHER (2017) 1-006.

A significant change in philosophical approach in insolvency law was brought about by the Enterprise Act 2002 with the introduction of a rescue culture towards the insolvent debtor and the institution, amongst others, of the administration procedure.[119] Following this shift in philosophical culture, Finch states that there are currently two strong threads of concern in English insolvency law namely to establish formal legal procedures for business rescue and the orderly realisation and distribution of assets, and to erect a regulatory framework that would prevent commercial malpractice and abuse of the insolvency procedures. Finch also notes a new emphasis on managing insolvency risks proactively rather than after troubles have become crises such as by means of the 'pre-packaged' administration.[120]

The recent financial crisis resulted in a further shift in approach. It has been recognised that the failure of banks may give rise to systemic risk. The failure of a large bank can have a domino effect leading to the collapse of the entire banking market as they may have substantial exposure to that bank through inter-bank lending. Failures of banks also have a great impact on depositors who may proceed to a bank run. It has been seen that the solution adopted by the UK Government to the crisis in legislative terms is by introducing the Banking Act 2009. This has changed the collective procedure for handling failures insofar as banks, and with the Investment Bank Special Administration Regulations[121] also investment banks, are concerned. Under the Banking Act banks undergo a special resolution regime when they are in or are approaching financial difficulty so that the trigger for the resolution of banks is a regulatory one as opposed to balance sheet or cash flow insolvency. Also, in line with modern resolution regimes, the judicial process of dealing with a failing bank has been largely replaced by an administrative process.

By way of preliminary analysis, the question arises as to how creditors benefiting from close-out netting rights feature under English insolvency law. Enforceable close-out netting arrangements grant preferential status to netting creditors and are only subject to the *pari passu* principle to the extent of the net amount which remains owing following the calculation of the close-out amount. Given the measure of self-help afforded to netting creditors, it is also the case that a liberal approach in the enforcement of close-out netting provisions would go contrary to the business rescue culture instilled by the Enterprise Act.[122] Considerations of financial stability taken from the perspective of a failing bank have brought significant erosion in

119 DTI 2001 Insolvency Consultation Document.

120 FINCH & MILMAN (2017) 15 *et seq*.

121 S.I. 2011/245.

122 As reiterated in part 4.3, the proposed Restructuring Directive would ensure that certain agreements such as close-out netting agreements concluded by two corporate entities none of whom is a financial institution will be subject to the stay from termination and execution of the agreements under Article 6 of this Directive and this would somewhat reinstate the business rescue culture between such entities.

the enforceability of close-out netting provisions in terms of the Banking Act 2009. Notwithstanding any applicable restrictions, the law provides protection to the rights of solvent netting creditors since, after all, these rights were initially granted for the sake of protecting against systemic risk and thus the law aims to achieve a balance between protecting financial stability and bank depositors on the one hand, and safeguarding the close-out netting mechanism on the other. Indeed, in one instance, namely in the case of suspension of termination rights under section 70C(4) of the Banking Act, the Bank of England is obliged to have regard to the impact which a suspension might have 'on the orderly functioning of the financial markets' before imposing a suspension, presumably since systemic risk and considerations of financial stability may also arise if the solvent creditor is restricted from exercising netting rights.

4.4.1 Principles Upheld by English Insolvency Law

English law recognises various principles which have shaped the application and interpretation of English insolvency law, a few of which have been mentioned in part 4.1 of this chapter. The following principles are considered the most relevant for the purposes of this research since they address pre-insolvency contractual entitlements in relation to which close-out netting rights can be assessed.

English corporate insolvency law recognises rights accrued under general law prior to liquidation. A distinction is made between two types of rights, namely personal rights which are rights against particular persons as in the case of debts and enforceable only against them, and property or real rights which are rights in respect of assets and generally enforceable against all persons as in the case of security interests or title transfers. Security interests and other real rights created prior to the insolvency proceeding are unaffected by the winding-up and the creditor to whom these rights pertain may proceed to realise its security or assert other rights of property as if the company was not in liquidation. On the other hand, English law generally stays performance of personal claims so that the pursuit of personal rights against the company is converted into a right to prove for dividend in the liquidation to participate in any *pari passu* distribution.

A contractual provision intentionally aimed at the removal of an asset from the estate of an insolvent company upon winding-up is void as contrary to public policy. This is referred to as the anti-deprivation rule. Contrary to what has been stated above, this principle refers to the acquisition of rights where the appointment of a liquidator is itself a trigger for a contractual provision divesting the company of an asset it previously held. Such a provision would contravene the anti-deprivation rule since its effect is to intentionally remove from the reach of the general body of creditors an asset held by the company at the time of the liquidation. This rule is aimed at transactions which improperly reduce the value of the company's assets to the detriment of all unsecured creditors.

Perhaps the most debated principle in relation to the enforceability of close-out netting provisions is that unsecured creditors rank *pari passu* meaning that unsecured creditors are required to share alike in the common pool of assets and proceeds. Fletcher explains that the ultimate rationale for this principle is that insolvency proceedings are essentially of a collective nature and that no individual creditor should be enabled to gain an unfair advantage relative to the rest.[123] This contrasts with the view expressed by Ho who states that the *pari passu* principle is to be strictly distinguished from the principle of collectivity that underlies such provisions as the automatic stay. According to Ho, the automatic stay is meant to maintain the *status quo* and conserve the insolvent's estate but they are not meant to preserve any particular level of priority in the distribution regime.[124] Mokal is of a similar view, stating that the *pari passu* principle has rather limited effect in governing distributions of the insolvent's estate. According to Mokal, the *pari passu* principle has a specific purpose which is to ensure that creditors who hold similar claims under non-insolvency law are to be paid back the same proportion of their debt in their debtor's insolvency and is to be deemed as one manifestation of formal equality in insolvency law which, according to this author, is determined by pre-insolvency law.[125]

Impact of Close-out Netting

Close-out netting rights may be deemed compatible with most of the principles mentioned above. Close-out netting rights, although designated as personal rights, are given preferential treatment similar to security rights which may be asserted upon insolvency provided they arise from arrangements entered into prior to insolvency and there was no actual or constructive knowledge of the commencement of insolvency proceedings. Close-out netting rights may be considered as pre-insolvency entitlements and may be deemed to have accrued under general law through the recognition of the principle of contractual freedom prior to liquidation. Close-out netting rights are not considered to breach the anti-deprivation principle unless they are triggered solely by the commencement of insolvency proceedings so that if they apply equally inside and outside of an insolvency situation, as a general rule there is no intention to remove an asset from the estate of the insolvent debtor in breach of the anti-deprivation rule. This approach has been confirmed by the court in *Belmont Park Investments PTY Ltd v BNY Corporate*

123 FLETCHER (2017) 1-006. Fletcher criticises the traditional view that the *pari passu* principle is the foundation of the entire insolvency system. He states that the development of English insolvency law is one of 'almost perpetual accretion and revision and shifting socio-political influences' with lack of coordination in the development of English credit, security and insolvency laws with the consequence that the law is 'beset by anomalies and inconsistencies, particularly concerning the pari passu principle, which are in some instances squarely at odds with commercial and social realities […]'. *Ibid.* para 24-052.

124 HO (2006) 1731.

125 MOKAL (2005) 92.

Trustee Services Ltd[126] where it was held that taking into account 'commercial sense and absence of intention to evade insolvency laws', the courts will seek to give effect to the contractual terms and hence to party autonomy in the application of the anti-deprivation rule and 'there is a particularly strong case for autonomy in cases of complex financial instruments [..]'.[127]

From the debate on the *pari passu* principle made above, it appears that the impact of close-out netting may vary depending on the interpretation given to this principle. According to Firth, for the *pari passu* rule to be engaged there has to be an attempt to apply an asset of a debtor in a way which is inconsistent with the statutory order of distribution. Firth opines that the multilateral netting arrangements in *British Eagle* were held to be invalid following the winding-up of British Eagle because the majority considered British Eagle's rights against another airline, *i.e.* Air France, to have a claim for services rendered to Air France settled through the netting arrangement, to be an asset of that company which should have been paid to the liquidator and not to Air France. The position would have been different if, as the minority concluded, British Eagle only had a claim for the net sum against the clearing house at the end of each month. Firth explains that the effects of a close-out netting agreement is to create a type of flawed asset whose terms are such that the obligations of each of the parties are conditional on no event of default having occurred with respect to the other and the non-defaulting party's obligation to perform the transactions in the manner originally contemplated arises only if the transactions have not been closed out. Thereafter, performance is to take place by the payment of any close-out amount that is due from the non-defaulting party. Firth opines that there is therefore no application of an asset in a manner that is inconsistent with the insolvency legislation since the defaulting party merely has a limited right under the contract.[128]

Mokal adopts a different perspective and states that what cannot be contracted out of is not the *pari passu* principle but the whole collective system for the winding-up of insolvent estates. According to Mokal, it is forbidden for a creditor to leave his assigned ranking in the distribution scheme since this would frustrate the rules of the insolvency regime. Mokal opines that the netting arrangements in *British Eagle* may be considered as an attempt on the part of IATA to prevent its members from having to submit to the collective liquidation regime. However, the contracting out as such was not objectionable as Lord Cross implied that had the IATA arrangements created charges in favour of the IATA creditors with effects

126 [2012] 1 All E.R. 505.

127 *Ibid.* para 103. The ISDA English Law Opinion confirms that the type of provisions entered into under the ISDA master agreements are capable of satisfying the *Belmont* test as they are entered into in good faith and without the purpose of depriving the insolvent party of its assets. *Ibid.* 30. But see HUDSON [2018] para 17-91 *et seq.* for a criticism of the good faith argument in the *Belmont* case.

128 FIRTH (2013) para 5.060.

equivalent to the disputed netting scheme, those would have been effective against the liquidator if duly registered. So, according to Mokal, the objection was not granting certain creditors priority over others, but rather that advantages associated with recognising this 'novel way of acquiring immunity' was not sufficient to outweigh the costs of such a significant derogation from the collective regime.[129]

The preferred view adopted in this research is that the reference to the novel way of acquiring immunity made by Mokal perhaps best describes the application of close-out netting in relation to English insolvency law. Close-out netting is clearly inspired by the set-off concept which is a fundamental concept under English law and has found its place among the category of rights which are given preferential treatment in the scheme of distribution. Any set-off amount left unsettled is then regulated by the *pari passu* regime. One important distinction, however, is that whilst insolvency set-off operates in terms of mandatory law, close-out netting is based on party autonomy. Given the UK's obligation to implement the EU's FCD, the recognition of insolvency close-out netting provisions under English law has been significantly influenced by the provisions of the FCD. What is unique about the English concept of close-out netting is that protection is extended to close-out netting agreements forming part of a financial collateral arrangement concluded between corporate parties, whether or not they are also financial market participants. This widened scope may have been influenced by the general applicability of insolvency set-off under English law. Indeed, it is interesting to note the comment made by the English legislator in the FCAR consultation document that:

> '[the] overall approach in implementing the [EU] Directive is to extend the scope and usefulness of financial collateral arrangements as widely as possible having regard to general UK policy on insolvency. […] We have sought to promote further flexibility in the use of financial collateral arrangements in order to assist the competitive position of London as an international financial market.'[130]

It appears that an additional consideration for widening the scope of protection of financial collateral arrangements under the FCAR to corporates was therefore to promote London as a global financial market. This indicates that the legislator may opt to shape the law to fulfil State goals, even if the resultant law may not fall squarely within the rationale of insolvency law.

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129 MOKAL (2005) 108.

130 HM TREASURY 2003 FCAR Consultation Document para 1.12. See also paras 2.2 to 2.4 of the FCAR consultation document.

4.4.2 Effect of State Goals on English Insolvency Law

The design of national insolvency law is invariably shaped by the goals set by the government of the day. In 1982, the Cork Report[131] laid the foundations for a new modern insolvency law. A White Paper[132] was issued in 1984, heralding the Insolvency Act. This Paper expanded on the Cork objectives by stressing the need to provide a statutory framework to encourage companies to manage the risks of their financial circumstances at an early stage, before prejudicing other creditor interests. The Insolvency Act of 1986 itself was based on two clear precepts, *i.e.* to establish formal legal procedures to business rescue and the orderly realisation and distribution of assets and to erect a regulatory framework to prevent commercial malpractice and abuse of the insolvency procedures. In 2002 there was a consolidation of the rescue culture brought about by the Enterprise Act and a new emphasis on managing insolvency risks proactively, with the intention to encourage more entrepreneurship.[133]

In more recent times, the legislator's attention has focused on the competitiveness of the financial markets. Finch notes that credit has become a commodity that is traded across the world in complex packages of debt so that relationships between lenders and borrowers have become more distant and less transparent.[134] This change has brought new risks which were unknown certainly at the time of the Cork Report and the Insolvency Act. Benjamin notes that the willingness of the financial markets to absorb new credit risk depends on the effectiveness of private and public law measures designed to ameliorate credit risk. At the same time any statutory pro-market measures could conflict with the distributive regime of insolvency law, including the *pari passu* principle.[135]

The tendency of English law has been to enhance the legal protection of the financial market. English law traditionally adopted a liberal attitude and placed heavy emphasis on creditors' rights, evidenced by the general principle on the respect for the pre-liquidation ordering of entitlements. Thus, the special treatment of the financial markets and related contracts is a significant exception to the application of general insolvency law principles.[136]

The question arises whether close-out netting arrangements effective under the party autonomy principle may be said to result from, or be in conformity with, these State goals. The FCAR was enacted in 2003, one year after the Enterprise Act. It cannot be said to favour the business rescue

131 Insolvency Law Review Committee 1982 Report.
132 DTI 1984 Cork Report.
133 FLETCHER (2017) 1-041.
134 FINCH & MILMAN (2017) 10.
135 BENJAMIN (2007) 39.
136 VAN ZWIETEN (2018) 350.

culture prevalent at the time. It is probably more appropriate to consider close-out netting arrangements in the light of protection given to market contracts in relation to recognised exchanges and clearing houses in Part VII of the Companies Act 1989 from the rules of insolvency law and the developments in the EU such as the adoption of the Finality Settlement Directive and the Financial Collateral Directive. These developments may be seen as an attempt to protect financial markets from systemic risk by exempting contracts such as close-out netting agreements from the ordinary effects of insolvency law. The problem with close-out netting arrangements under the FCAR is that their scope goes beyond aspects of systemic risk since even arrangements between corporates are protected with the result that the balancing between the interests of corporate netting creditors and other unsecured creditors may be disproportionate. It is suggested that this widened application under the FCAR may be best explained by the declaration made in the FCAR consultation document that this serves to enhance the competitiveness of the London financial market, given the importance of the netting mechanism to reduce credit and other risks.

Close-out netting may be considered a classic example of a concept which has been heavily shaped by the goals of the State. Thus, although the statutory recognition of party autonomy under English law occurred on account of the implementation of the EU's FCD, however the legislator extended its scope to corporates in order to implement the State goal of enhancing London's position in the global financial market. The recognition of party autonomy was both curtailed and safeguarded by the Banking Act in 2009. In this case the regulation was not, at least initially, triggered by EU law since the BRRD was adopted at a later stage. Some fine-tuning did take place in the law as a result of the implementation of the BRRD, which has served to further safeguard both the effectiveness of resolution measures as well as the rights of the solvent creditor benefiting from the netting arrangement. The law is therefore in the process of continuous re-evaluation of the scope which close-out netting is meant to achieve and in the process the balancing of interests affected by the close-out netting process and the party autonomy role in the enforcement of close-out netting provisions are also being re-assessed.

4.5 Preliminary Conclusions

Under English law, insolvency close-out netting provisions are currently regulated by three regimes, namely by the mandatory provisions of rule 14.25 of the Insolvency Rules 2016 in cases where the close-out netting provision fulfils the conditions of insolvency set-off, by the FCAR in the case of close-out netting provisions concluded by corporates as part of financial collateral arrangements and by the Banking Act in relation to all close-out netting provisions, whether governed by English or a foreign law, which have been entered into by a failing banking institution.

First Sub-question

Notwithstanding the standard set in the FCAR that close-out netting arrangements are to take effect in accordance with their terms, this standard is subject to conditions and exceptions. The first major exception relates to the mandatory operation of rule 14.25 of the Insolvency Rules 2016 which applies automatically in relation to executed contracts satisfying the requirements of this rule. Those which do not and executory contracts which fall within the scope of the FCAR, are protected insofar as there is no actual or constructive knowledge of the commencement of insolvency proceedings. Some doubt may be shed on this statement by regulations 12(4) and 14 of the FCAR which disapply only certain provisions on set-off in relation to close-out netting arrangements and may raise questions on the continued applicability of the other provisions. The preferred view expressed in this research is that these provisions should not be interpreted to imply that the other provisions on set-off are intended to apply to close-out netting arrangements benefiting from the party autonomy rule set in regulation 12 of the FCAR. Thus, in a preliminary reply to the first sub-question raised in the Introduction, the influence of insolvency set-off rules on the recognition granted to close-out netting depends on the scope of application of the arrangement of which the close-out netting provisions forms part. Generally speaking, those provisions falling within the scope of application of the FCAR are given recognition 'in accordance with their terms' and are not affected by insolvency set-off rules. On the other hand, close-out netting provisions not falling within the scope of the FCAR may need to be tailored on the mandatory rules of insolvency set-off in order not to be impugned in court as an attempt by the parties to contract out of the insolvency law.

Second Sub-question

English insolvency law generally enforces pre-insolvency contractual entitlements and recognises specified groups of preferential interests so that the preference given to close-out netting is aligned with English insolvency law principles. Hence, it appears that in relation to the second sub-question raised in the Introduction, English insolvency law would favour that close-out netting provisions take effect 'in accordance with their terms'. However, given the wide scope of application of the close-out regime under the FCAR, it is debated by English authors whether the preference given to netting creditors can be considered a proportionate departure from the *pari passu* principle. Considerations of credit risk, systemic risk and financial stability may have formed the basis of the EU's Financial Collateral Directive. However, the widened scope of the FCAR to cover also agreements between corporates takes the realm of the FCAR beyond justifications of systemic risk. It has been suggested that the reason for this approach may be the need to fulfil the State goal of enhancing the competitiveness of London as a global financial centre declared by the legislator in the FCAR consultation document. Given the central place occupied by close-out netting in financial agreements, in particular to reduce credit risk, it is understood that the legal soundness of close-out netting provisions will go a long way to promote London as a financial centre. Thus, whilst the nature of the preferences given to netting creditors may raise the debate on proportionality *vis-à-vis* the *pari passu* principle, the preferential treatment may be explained in the light of insolvency goals set by the state which favour the competitiveness of the market.

Third Sub-question

Close-out netting arrangements protected under the FCAR are made subject by regulation 12(5) to any restrictions that may be imposed by the Bank of England under the special resolution regime of the Banking Act 2009. Although this rule is termed very generically and may be widely interpreted to include any possible power that may be exercised by the Bank of England under the special resolution regime, the view taken in this research is that close-out netting arrangements, whether governed by the FCAR or not, are currently affected in three ways by the Banking Act 2009, namely in the exercise of termination rights, in property transfers and in the bail-in of net amounts. To interpret regulation 12(5) otherwise would imply that netting arrangements falling within the scope of the FCAR receive less protection than those which do not fall under the FCAR but which are still affected by the Banking Act. It has been seen that the Banking Act provisions do restrict contractual freedom insofar as concerns close-out netting arrangements to ensure the effective exercise of resolution measures, but this is being done with due consideration to the fact that the rights of netting creditors should not be unduly restricted and safeguards have been put in place. Although there is a significant loss of party autonomy, this may not always have negative repercussions. Thus, in the case of a transfer of contracts, the netting creditor may end up with a better counterparty whilst in the case of bail-in of net amounts the creditor should not be in a worse-off position than under normal insolvency proceedings. Whilst the analysis of the provisions of the Banking Act and the manner in which they affect close-out netting rights is important towards providing a reply to the third sub-question raised in the Introduction, the resolution regimes of the other two regimes need to be analysed prior to giving a preliminary reply to the question whether there is convergence in the type of restrictions imposed by the three selected resolution regimes. This analysis is therefore reserved for Part III.

5 Insolvency Close-out Netting under French Law

5.1 Overview of the Regulation of Insolvency Close-out Netting under French Law

Whilst in Chapter 4 the recognition of close-out netting provisions was considered from the perspective of English law which is based on the common law tradition, the same consideration will be made in this chapter in respect of French law which belongs to the civil law group. The assumption is that given the different legal traditions of these two bodies of law, an analysis of French law should or may bring out a different perspective of the treatment of insolvency close-out netting. Consistent with the approach taken in the English law chapter, the first part of this chapter will give an overview of the insolvency and bank resolution rules applying under French law and in relation to which a derogation applies in favour of close-out netting provisions. This is followed by a preliminary analysis of the law regulating insolvency close-out netting, including an assessment of the scope of these rules.

Insolvency Rules

French insolvency law proceedings are regulated by Book VI of the Commercial Code. This branch of French law is one characterised by continuous change, with major amendments being initiated in 1967 by Law no. 67-563 of 13 July 1967 which established a dual approach to insolvency, according to which a business could be either rescued or liquidated.[1] The term bankruptcy (‘*faillite*’) was, until 1967, the generic name given to insolvency proceedings. The legal terminology nowadays is ‘collective proceedings’ (‘*procédures collectives*’) or also ‘law of businesses in difficulty’ (‘*droit des entreprises en difficulté*’) which terminology is reflected in the title given to Book VI and which is typically used to describe French insolvency proceedings where the debtor is in a payment cessation situation.[2]

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1 Book VI applies to both corporate and individual insolvency proceedings. The Commercial Code was enacted in 2000 as part of the bicentenary celebrations of the codification project inaugurated by Napoleon. For a description of the main changes to French insolvency laws throughout modern times, see COUTURIER (2013) 14.

2 Hervé Synvet, ‘The Exclusion of Certain Creditors from the Law of Collective Proceedings’, in RINGE *et al.* (2009) 159. Under French law, a situation of cessation of payments (‘*cessation des paiements*’) arises when a debtor is unable to meet current liabilities out of disposable assets as provided by article L.631-1 of the Commercial Code. The French insolvency test is therefore a cash-flow test.

There are three main types of collective insolvency proceedings under French law which may be considered relevant to the application of insolvency close-out netting provisions. These proceedings apply to self-employed individuals as well as to all types of legal entities. The main type of insolvency proceeding following the 1967 amendments is judicial restructuring (‘*redressement judiciare*’)[3] aimed at allowing a debtor company to recover from financial difficulty or to have the business sold as a going concern. Where there are prospects that the business can recover, the court will make an order for the start of restructuring proceedings subject to the supervision of a court-appointed administrator, a supervising judge and a creditors’ representative. A moratorium on creditors’ claims is imposed and the creditors must, as a general rule, accept any reorganisation plan that is approved by the court. Judicial restructuring culminates in a court decision that usually adopts the recommendation of the court-appointed administrator on whether a business should operate under a continuation plan, be sold under a sales plan, or be liquidated.

The second is the judicial liquidation (‘*liquidation judiciare*’) procedure which is resorted to if there is no possibility to restructure the business.[4] A liquidator is appointed to represent the dispossessed debtor and to liquidate all the assets of the debtor with a view to maximising proceeds. It is common for the court to nominate as liquidator the creditors’ representative initially appointed in the context of restructuring proceedings. In liquidation proceedings, creditors expect to be paid from the proceeds realised from the sale of the debtor’s assets. Claims are accelerated in the sense that they become immediately payable on the day of the opening of the proceedings. The liquidator appointed by the court receives lodged claims and is responsible for checking them, before proceeding to draw up a scheme of distribution.[5]

The third is the safeguard proceeding (‘*procédure de sauvegarde*’) introduced in 2005 by Law no. 2005-843 of 26 July 2005. This procedure has been tailored on Chapter 11 proceedings in the United States. Unlike the judicial restructuring or judicial liquidation proceedings, safeguard proceedings may be requested in favour of a debtor who is not yet insolvent and serves to suspend action by individual creditors. The debtor, however, needs to demonstrate financial difficulties that may lead to cessation of payments.[6] This is intended to create an early warning mechanism that would prevent failing businesses from becoming insolvent and provides for a six-month ‘observation period’, renewable for up to eighteen months, during which the debtor will negotiate with its creditors a rescheduling or waiver of debts

3 This procedure is also referred to as judicial reorganisation, judicial recovery or administration procedure.

4 See article L.640-1 of the Commercial Code.

5 The order of priority of payment is established under articles L.622-17 and L.641-13 of the Commercial Code. See in this respect SAINT-ALARY-HOUIN (2013) 420.

6 See article L.620-1 of the Commercial Code.

in the framework of a safeguard plan. The court will appoint a judicial administrator to supervise or assist the debtor and a creditors' representative to receive and verify declarations of claims. Further developments of the safeguard proceeding resulted in the establishment of an accelerated financial safeguard proceeding ('*sauvegarde financière accélerée*') and an accelerated safeguard proceeding ('*sauvegarde accélerée*') introduced by Law no. 2014-1 of 2 January 2014 which enable *inter alia* the implementation of pre-packaged plans, based on the 'pre-pack' procedure introduced in England under the Enterprise Act 2002.

Finally, French law provides for two amicable proceedings which may be considered as preventive measures, namely the conciliation procedure, whereby the creditors and the debtor may reach a contractual arrangement under the supervision of a conciliator appointed by the court to defer payments or agree on reductions on amounts due, and the appointment of an *ad hoc* representative ('*mandataire ad hoc*') to perform a mission as defined by the court. The latter can also play the role of conciliator but without being bound by the rules governing the conciliation procedure. These proceedings do not lead to a stay of payment or a stay of proceedings on creditors unless agreed to voluntarily.

A number of principles apply in relation to French insolvency collective proceedings, some of which directly affect the operation of insolvency close-out netting provisions. An important rule applied in relation to French collective insolvency proceedings is to 'freeze' the claims of creditors during the observation period in relation to both payment of money and the termination of contracts for payment default.[7] Under French law the aim of the observation period is to protect the debtor's assets and allows the court to determine the fate of the company. The commencement order stays claims arising prior to the commencement order.[8] For claims that arise after the commencement order, the principle is that where they are properly incurred for the conduct of the proceedings, they should be paid without delay, unless contractually provided otherwise.[9]

A form of 'cherry-picking' rule applies also under French law. This arises from article L.622-13 of the Commercial Code which allows the debtor company in the course of an observation period during safeguard or reorganisation proceedings to demand that the other party continue to

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7 See article L.622-21 of the Commercial Code. Citing jurisprudence, Roussille confirms that these are public policy rules and cannot be derogated from by contract unless such derogation is foreseen in the law. ROUSSILLE (2006) 392. See also SAINT-ALARY-HOUIN (2013) 36.

8 There are exceptions to this rule such as in relation to payment by way of set-off of connected claims (see article L.622-7, I of the Commercial Code) or to the rights of creditors protected by a security *in rem* or where this is warranted for the continuance of business, for instance where the court authorises the debtor to pay to obtain a thing pledged. See Hervé Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', in RINGE *et al.* (2009) 160.

9 See article L.622-17, I of the Commercial Code.

perform the contract even if it has not been paid for past services. As this rule seems unfair, the contract can only be maintained if the appointed administrator has sufficient funds to pay for the requested services.

The *pari passu* rule also features under French insolvency law and applies to those classes of creditors who are not otherwise privileged in terms of articles L.622-17 and L.641-13 of the Commercial Code. Contrary to the situation under English law, the *pari passu* principle does not seem to be the subject of controversial debate amongst French legal writers in relation to the implications of any priority treatment given to contractual entitlements in an insolvency situation. It may be noted that this rule was strengthened by the 2014 amendments since creditors have been made subject to a new requirement to restore to the insolvent estate any sums received in breach of the *pari passu* rule or that result from a mistake as to the order of priority.[10]

On 26 July 2013, Law no. 2013-672 introduced, *inter alia*, a new banking resolution regime.[11] The adoption of this 2013 Law was the response of the French legislator to implement the Key Principles of the FSB into French law, in particular to implement the rule imposing a temporary stay pending a decision on resolution measures. This was replaced by Ordinance No. 2015-1024 of 20 August 2015[12] which implements the provisions of the BRRD, subsequently ratified and further amended by Law no. 2016-1691 of 9 December 2016. Today the updated provisions are codified in article L.613-34 *et sequens* of the Monetary and Financial Code (the Financial Code). The resolution regime is applicable to banks, financing companies, mixed holding companies and investment firms.[13] In terms of article L.613-49, II, the resolution college of the *Autorité de contrôle prudential et de résolution* (ACPR)[14] may initiate resolution proceedings if any of the institutions mentioned above is failing and such failure may not be otherwise avoided than by the implementation of a resolution measure.[15] The objective of resolution measures are said to be to ensure the continuity of critical functions, avoid financial instability, protect state resources and protect the funds and assets of clients, in particular insured deposits.[16] Under a resolution

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10 Article L.643-7-1, Commercial Code, inserted by Article 76 of Ordinance no. 2014-326 of 12 March 2014.

11 The provisions of the 2013 Law were codified as (former) article L.613-31-11 *et seq.* of the Financial Code. See KANNAN (2015) para 3.

12 For a general overview of the differences between the 2013 and 2015 Laws, see BONNEAU (2015) para 14 *et seq.*

13 See Article L.613-34 of the Financial Code for a full list of institutions, including applicable exceptions.

14 The ACPR is responsible for supervising the banking and insurance sectors in France. It is an independent administrative authority attached to the Banque de France, *i.e.* the central bank of France. See the website of the ACPR at < https://acpr.banque-france.fr/en/home.html>.

15 See article L.613-48 of the Financial Code.

16 See article L.613-50 of the Financial Code.

proceeding, the ACPR may adopt a number of resolution measures which may range from requesting information to appointing a special resolution administrator, transferring all or part of a business activity, activating the loss absorption clause of subordinated bonds, mandatory recapitalising of the failing entity, suspending obligations and payments, and the exercise of the bail-in tool in relation to capital and specified liabilities.

This brief overview of French insolvency rules indicates that collective proceedings have traditionally been controlled by the courts. Today French resolution laws give significant discretionary power to the resolution college of the ACPR and this power may be used also to intervene at the early stages of the failure situation in order to prevent further financial deterioration.

The Close-out Netting Provisions of the Financial Code

The main law regulating close-out netting provisions under French law is Section 4 of the Financial Code, with particular reference to article L.211-36-1.[17] This Section 4 implements the EU's Financial Collateral Directive. Contrary to the FCD, however, the French financial netting regime is not restricted to financial collateral arrangements but extends to both collateralised and non-collateralised agreements.[18] Article L.211-36-1 of the Financial Code sets the main rule allowing parties to set off debts and receivables arising under agreements relating to financial obligations referred to in article L.211-36 so that one net sum becomes payable. Article L.211-36 of the Financial Code lists four types of financial obligations:

(a) Those arising from operations in financial instruments as defined in article L.211-1, I of the Financial Code where at least one of the parties is a regulated or eligible person;
(b) Those arising from contracts relating to financial obligations giving rise to cash settlement or to the delivery of financial instruments where all the parties are eligible regulated persons, with the exception of entities referred to in paragraphs (c) to (n) of article L.531-2 of the Financial Code;[19]

17 Pursuant to Ordinance no. 2009-15 of 8 January 2009, article L.211-36-1 replaces the former article L.431-7 of the Financial Code. An examination of the evolution of close-out netting under French law will be carried out later in this chapter. For an account of the different types of netting, see ROUSSILLE (2006) 9; DELOZIÈRE-LE FUR (2003) 46.

18 See ISDA 2018 Jones Day, 9.

19 See article L.211-36-2 of the Financial Code. The terms used in this article namely '*aux obligations financières résultant de tout contrat donnant lieu à un règlement en espèces ou à une livraison d'instruments financiers*', are very wide and may be considered to cover a wide range of contracts. According to the ISDA French Law Opinion, the obligations under this provision need only qualify as 'financial obligations' within the meaning of the EU Financial Collateral Directive. See ISDA French Law Opinion at p 21.

(c) Those arising from a contract relating to financial obligations concluded in the framework of a system mentioned in article L.330-1 of the Financial Code;[20]
(d) Those arising from contracts relating to financial obligations concluded by one or more clearing houses and their participants or between these participants and their clients which directly or indirectly[21] offer set-off services between their clients and the clearing house, and which involve the setting off of claims.

For the purposes of this provision regulated or eligible persons comprise a credit institution, a financing company, an investment services provider, a public body (établissement public), a local government (*collectivité territoriale*), an entity listed in article L.531-2 of the Financial Code,[22] a clearing house, a non-resident establishment with a comparable status and an international financial organisation or body of which France or the EU is a member.

The financial instruments referred to in (a) and (b) above are primarily those listed in article L.211-1[23] of the Financial Code which include financial securities, namely equity securities issued by joint-stock companies, debt securities with the exception of bills of exchange and interest-bearing notes, and units or shares in undertakings for collective investment, as well as financial contracts as defined in article D.211-1 of the Financial Code. To this list, article L.211-36 of the Financial Code adds units listed in article L.229-7 of the Environmental Code, spot FX transactions or purchase, sell or delivery transactions in gold, silver, platinum, palladium or other precious metals, options, futures, swaps and all forward contracts provided that where instruments require physical settlement, they are registered by a recognised clearing house or they are the subject of regular requests for cover.

20 Article L.330-1 of the Financial Code implements the EU's Finality Settlement Directive and refers to systems for interbank settlements and settlement and delivery of financial instruments and provides the criteria for such a system. The consideration of netting provisions in relation to systems falls outside the scope of this research.

21 Whilst the reference to indirect set-off is being used in the context of clearing systems and may constitute a reference to the technical arrangements of such systems, it will be seen in part 5.2 of this chapter that both set-off and netting must involve bilateral mutual relationships to be effective. This distinction is also made by Bonneau *et al.* who consider that set-off and netting are based on the contract itself concluded between the parties, whether the relationship is bilateral or is regulated by a multilateral mechanism such as a clearing system. See BONNEAU *et al.* (2017) para 934.

22 The entities referred to by article L.531-2 of the Financial Code which fall within the scope of article L.211-36 *et seq.* of the Financial Code are primarily (i) public financial institutions such as the *Trésor Public,* the *Banque de France, La Poste,* the *Institut d'Emission des Départements d'Outre-Mer,* the *Institut d'Emission d'Outre-Mer* and (ii) insurance and reinsurance companies, collective investment schemes, *fonds comuns de créances* (French securitisation vehicles), *sociétés civiles de placement immobilier* (a type of building company) and management companies.

23 But excluding those listed in article L.211-1, III of the Financial Code. See article L.211-36, II of the Financial Code.

In its scope of application article L.211-36-1 of the Financial Code reflects a partial opt-out permitted by Article 1(3) of the FCD. The FCD permits Member States to limit the application of the FCD regime to financial collateral arrangements concluded between regulated or public entities. Article L.211-36-1 of the Financial Code recognises arrangements concluded between any parties but if one of the parties is not an eligible entity, then the arrangement must relate to one of the financial instruments listed in article L.211-1 of the Financial Code or others referred to in article L.211-36. If both are eligible parties, then the wider FCD regime becomes applicable and the field of application is not limited to transactions involving financial instruments but all contracts related to payment of cash or transfer of title.[24] Article L.211-36-1 of the Financial Code would not apply at all if none of the parties to a financial agreement is an eligible party.

Paragraph II of article L.211-36-1 of the Financial Code then provides that the contractual terms of cancellation, valuation and set-off applicable to transactions and obligations referred to above are effective as against third parties and may be included in agreements or master agreements. This covers the ability of the parties to incorporate in the close-out amount termination values of different types of transactions which, in terms of the ISDA French Law Opinion 'if performed in good faith, using pre-agreed determinable means and commercially reasonable procedures and rules to produce a commercially reasonable result, should be enforced by a French court'.[25] The net amount remaining to be paid after the netting is to be filed as a claim with the Creditors' Representative in order to be taken into account.[26]

Article L.211-40 of the Financial Code applies a derogation of these mechanisms from the provisions of Book VI of the Commercial Code, as well as from any provision regulating judicial or amicable proceedings instituted on the basis of foreign legal systems.[27] This rule has the effect of exempting this mechanism from the moratorium which accompanies

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24 Praicheux, commenting on similar wording in relation to the former article L.431-7 of the Financial Code, states that when the law provides for the material scope of application in relation to parties, one of whom is not an eligible person, it refers to *financial obligations* resulting from operations of financial instruments generally and does not mention any contractual arrangements, whilst when it refers to obligations in relation to parties both of whom are eligible, it refers to *financial obligations resulting from any contract* giving rise to payment of money or transfer of title. Praicheux notes however that in reality the omission of referring to a contract in the first category is not a material one given that in the end the law provides that the modalities of termination, evaluation and set-off of the obligations may be those stipulated by contract or master agreement so that in both cases a contract may be in existence. PRAICHEUX (2005) para 22.

25 ISDA French Law Opinion at p 11.

26 See ISDA French Law Opinion at p 12.

27 It is interesting to note that there is no imposition of the knowledge or constructive knowledge test of the impending insolvency existing under English law for the derogation to apply.

the opening of any type of collective procedures. It also derogates from the power of the judicial administrator to demand the continuity of contracts in terms of article L.622-13 of the Commercial Code with the cherry-picking risks that this entails. Also, the right to proceed to net reciprocal claims notwithstanding the opening of an insolvency collective procedure is an exception to the provisions of article L.622-7 of the Commercial Code prohibiting the payment of pre-existing claims. Although not related to insolvency proceedings, article L.211-40 of the Financial Code also protects close-out netting provisions from the rules of article 1343-2 of the Civil Code on the compounding of interest.

5.2 Constitutive Elements of Insolvency Close-out Netting

In contrast with English law which, as seen in the previous chapter, provides multiple definitions of close-out netting, French law does not provide any definition of this term in relation to article L.211-36-1 of the Financial Code and hence an indication of the constitutive elements of close-out netting under French law has to be sought from other sources. Another possibility is to consider the definition of set-off arrangement (‘*accord de compensation*’) provided under article L.613-34-1-19° of the Financial Code in relation to the bank resolution regime which could also shed light on the close-out netting concept.

The main elements of article L211-36-1 of the Financial Code may be listed as follows:

(a) The financial arrangement must fall within the scope of application of article L.211-36 of the Financial Code,
(b) The financial obligations under said arrangement may be terminated,
(c) The debts and credits related to said arrangement may be set off between all parties,
(d) The parties may establish a single amount, whether or not these financial obligations are governed by one or more agreements or master agreements,
(e) The modalities of termination of the financial obligations, of their evaluation and of their set off may be those foreseen in the relevant agreements or master agreements and are enforceable as against third parties.

The French legislator has implemented the FCD in three segments of the Financial Code. First, article L.211-36 sets the scope of application by defining the applicable parties and financial obligations, which are not necessarily collateralised obligations. Second, article L.211-36-1 regulates the enforceability of close-out netting provisions within the scope of article L.211-36 and, third, article L.211-38 sets the rules on the regulation and formalities of financial collateral regulations. Paragraphs I and IV of article L.211-38 create the link between the three segments by recognizing the possibility to set off collateralised financial obligations pursuant to the provisions of article L.211-36-1, I, so that in the end close-out netting provisions are protected to the same extent in relation to both collateralised and uncollateralised arrangements. The three main phases of the concept of close-out netting described in Chapter 1, namely termination, valuation and determination of a net balance, also feature in this article. Some preliminary observations may be made in respect of these phases as they apply in terms of article L.211-36-1.

First, there is a marked absence of any reference to the occurrence of an event of default which typically triggers the termination phase. Article L.211-36-1, I refers to the possibility to terminate financial obligations under an agreement, including a master agreement, and it is further stated in paragraph II of the same article that the modality of termination may be that provided for in the agreement or master agreement concluded between the parties. It is therefore understood that the termination will be in accordance with the provisions of the agreement or master agreement which typically provide for an insolvency event to be a trigger for the early termination of outstanding transactions. It may therefore be assumed that the event of default triggering the termination of financial obligations under article L.211-36-1 may be related to insolvency. This interpretation is confirmed by article L.211-40 of the Financial Code when it protects the enforceability of a close-out netting provision from the rules on collective insolvency proceedings or amicable proceedings. However, the termination of transactions remains a contractual faculty, meaning that the agreement must clearly stipulate the manner in which termination operates and the events by which it is triggered. As a consequence, the French courts have held that if for instance a contract foresees the termination of transactions upon the opening of judicial restructuring procedures but does not specifically include safeguard procedures, then the courts will imply that the parties intended to limit the events of default triggering the termination of transactions to the cases where the debtor is unable to pay its debts and hence that the clause does not extend to the case of safeguard procedures.[28]

Second, linked to the issue of termination of obligations following an event of default is the fact that article L.211-36-1 does not refer to the acceleration of the maturity of obligations. For the same reasons explained above, a master agreement will typically provide for the acceleration of obligations in order to terminate and close-out and the maturity of obligations will necessarily be accelerated if it is to be made due and payable using the set-off process referred to in article L.211-36-1, II. This interpretation is confirmed by French doctrine where the termination of transactions is deemed to include the acceleration of their maturities if this is required to

28 *CA Paris*, 21 June 2011, no. 10/20873, *SA Crédit du Nord c/ SCP Angel Hazane:* JurisData no. 2-11-020167; BRDA 18/11, no. 7. See also JURISCLASSEUR (2013) Fasc. 2050, para 83.

achieve termination under a close-out netting provision.[29] According to French doctrine, acceleration is also possible notwithstanding the provisions of article L.622-13 of the Commercial Code which permits the administrator to enforce outstanding contracts and to prevent the acceleration of their obligations.[30]

Third, article L.211-36-1, I refers to financial obligations under agreements or master agreements being '*compensables entre toutes les parties*' ('capable of being set off between all parties'), which might give the impression that this article envisages that close-out netting is possible in multilateral, and not solely bilateral, agreements.[31] However, it will be seen later in this chapter that the reference to the possibility to set off in this provision ('*compensables*') can only be to bilateral agreements, thus excluding multilateral ones, on account of the regulation of set-off under French law which imposes reciprocity as a mandatory requirement and thus presupposes the existence of bilateral and personal relations.[32] The wording used in the law may be an inadvertent reminiscence of the fact that originally netting was permitted on exchange traded financial instruments involving multilateral parties.

Fourth, this article foresees the possibility of establishing a single amount provided the applicable financial obligations are governed by '*une ou plusieurs conventions ou conventions cadre*' ('one or more agreements or master agreements'). French law thus explicitly allows for the possibility

29 JURISCLASSEUR (2013) Fasc. 3220, para 44. Referring to the joint application of articles L.211-36-1, II and L.211-40 of the Financial Code, it is stated in this paragraph 44 that; '[…] *la partie non défaillante est, en cas de "faillite" de sa contrepartie, autorisée à résilier l'opération et à prononcer ainsi son exigibilité anticipée; c'est ce que signifient les termes "close out" (accélération)* […]'. Thus, according to this text, the solvent party may, in the case of the insolvency of its counterparty, terminate the transaction and declare its accelerated payability, since close-out is taken to include acceleration. This is confirmed by Auckenthaler in relation to the interpretation of the former article 52 of Law no. 96-597 of 2 July 1996 which has been replaced by article L.211-36-1 of the Financial Code and in this respect contains the same wording. See AUCKENTHALER (1996) para 5.

30 JURISCLASSEUR (2013) Fasc. 3220, para 44.

31 Indeed, this interpretation was supported by writers in the past. For instance, Auckenthaler whilst interpreting the provisions of article 52 of Law no. 96-597 of 2 July 1996 refers to bilateral or multilateral master agreements, but then quotes types of agreements such as the ISDA master agreement which are intended to cover only bilateral arrangements. He also states that the words used in article 2 of the law of 1885 referred to agreements concluded between at least two parties ('*entre deux parties au moins*'). Similarly, Terret interprets the concept of netting to refer to set-off between multilateral parties. Terret explains that whilst only bilateral set-off is foreseen under the (former) article 1289 of the Civil Code, multilateral set-off is possible in the framework of netting between eligible institutions as foreseen under the (former) article L.431-7 of the Financial Code. See AUCKENTHALER (1996) paras 14 & 21; TERRET (2005) 49. Delozière-Le Fur, however, states that the resort to 'multilateral netting' in clearing systems is not netting at all but partakes of the nature of assignment of debts ('*cession de créances*') regulated by (former) article 1295 of the Civil Code so that netting *strictu sensu* should only comprise bilateral relationships. See DELOZIÈRE-LE FUR (2003) 82.

32 ROUSSILLE (2003) 81.

of cross-product netting or, what is more frequently referred to in French doctrine, global netting, which would imply that whilst reciprocity is still a requirement, there is either no connexity requirement between the financial obligations for netting of cross-product agreements to be enforceable or, alternatively, the connexity requirement is widely interpreted to cover instances where obligations are linked through multiple contracts relating to a bilateral relationship. This point is further analysed in the part of this chapter dealing with the comparison between set-off and netting.

Fifth, article L.211-36-1, II provides, *inter alia*, that the modalities for the termination, valuation and set-off of financial obligations may be as provided for in the agreements or master agreements concluded between the parties. First of all, this article envisages that these modalities may be set by applicable agreements ('*Ces modalités* ***peuvent*** *être notamment prévues par des conventions ou conventions-cadres*'), but it does not appear to be necessarily so. This leaves open the possibility that if not set by agreement, these may possibly be set by statute or even by judicial declaration. In the case of global netting, however, it is mandatory that the mechanism to set off the various close-out amounts under the different agreements is stipulated by contract since global netting does not operate automatically but must have been devised in the contractual documentation of the parties.[33] Secondly, it has been argued above that termination by acceleration, although not stipulated in the law, is possible since this method is typically envisaged in master agreements. By the same argument, the modalities related to calculation typically resorted to in master agreements, although not specified in the law, may be assumed to be enforceable. Thus, it has been seen that the two most common types of calculation methods in master agreements are the estimation of the current value of outstanding obligations or, in the case of derivatives, their replacement cost. Though not spelt out in the law, it is presumed that these will be enforceable given the liberal terminology used in paragraph II.

Finally, article L.211-36-1 refers only to the set-off modality in order to achieve a single amount which is due. This may be only a linguistic issue since the term coined by French jurists for close-out netting is '*résiliation-compensation*'[34] so that the reference to '*compensation*' and '*compensables*' may signify nothing more other than that the word 'netting' as such has not been imported into French law, at least not at the time the law was written. This seems to be the case given that the same article does not restrict the modality of set-off to the provisions of French law but extends it to any modality envisaged in the agreements or master agreements concluded between the parties.

Moving on to the definition of a set-off arrangement under article L.613-34-1-19º of the Financial Code, it is to be noted that this is a functional definition meant to serve the specific purposes of French bank resolution

33 JURISCLASSEUR (2013) Fasc. 2050, 29.
34 ROUSSILLE (2001) 4.

law. Although it may appear to focus on the termination aspect of the arrangement, the term *'droit de résiliation'* is defined in paragraph 17^0 of the same article to include not only termination and acceleration, but also any right to set off, to convert into a single amount and to extinguish or modify a contractual obligation. Aspects emerge from this definition which could support the interpretation given above to article L.211-36-1. Thus, this definition stipulates that termination may be exercised by acceleration of maturity ('*après déchéance de leur terme*') and also refers to two modalities for determining a single amount, namely by conversion ('*convertis*') and by set-off ('*compensés*'), rather than just set-off as stated in article L.211-36-1. Thus, the set-off mechanism may be considered as one, out of multiple, ways how to determine a net amount. One may think that the French legislator has taken the opportunity to modernise the notion of close-out netting by stipulating these additional details in this relatively new definition. However, the idea of clarifying the notion of close-out netting may not have been foremost in the legislator's mind since this definition ends by including within its scope any arrangement which gives to one of the parties the right to terminate ('*y compris tout accord conférant à l'une des parties un droit de résiliation*'). Thus, the legislator may have been more concerned to cover any possible situation where contractual arrangements may confer termination rights, rather than to finetune or modernise the concept of close-out netting.

Given the close affinity of set-off with netting, the question may be raised whether under French law the concept of netting is so intertwined with that of set-off that the rules governing the latter also need to be satisfied in relation to close-out netting. The terminology of article L.211-36-1, II may give this impression since the only modality mentioned to determine a single netting amount is that of set-off ('*compensation*'). In relation to the connection between set-off and netting, Roussille explains that with the development of the OTC market, the fight against systemic risk and competition with other financial centres rendered it necessary to protect close-out netting in order to eliminate risks of legal unenforceability of close-out netting arrangements for operators residing in France. Following this recognition, the French legislator had a choice to either create a *sui generis* mechanism which achieves the same result as close-out netting or to resort to existing mechanisms under French law and protect them from the collective procedure. Roussille concludes that the legislator took the latter option and combined two classical techniques, namely termination ('*résiliation*') and set-off ('*compensation*'), with the result that netting under French law consists simply in one of the parties being able to terminate outstanding operations on account of the risk of insolvency of the counterparty and to set off the value of the terminated obligations to determine a net amount. The former corresponds to the closing out and the latter to the netting. According to Roussille, the novelty of this new mechanism lies in its juridical implications since it applies notwithstanding the provisions of any other law to the contrary.[35] In the light of this statement, it is proposed to give an overview of the concept of set-off under French law which will enable a comparison to be subsequently made between the two notions for the purpose of determining whether the close-out netting concept is to be considered as a contractual enhancement of set-off and whether it is influenced by the rules of set-off.

5.2.1 Insolvency Set-off under French Law

The provisions on set-off under French law are currently contained in articles 1347 and 1348 of the Civil Code under the heading 'Extinguishment of obligations' ('*L'extinction de l'obligation*') since set-off under French law is considered as a means of payment.[36] These articles were introduced by Ordinance no. 2016-131 of 10 February 2016 and since 1 October 2016 replace the former articles 1289 to 1299 of the Civil Code which were in existence since Napoleonic times and were enacted in 1804 by Law 1804-02-07.

Set-off under French law is a bilateral operation which requires mutuality and which may be invoked when the parties are reciprocally debtor and creditor towards each other. Thus, the buyer of a specified asset may seek set-off of the purchase price payable by it to the seller against damages payable to it by the seller in respect of defects affecting the asset sold. For this reason, the triangular relationship between members of the same group does not permit setting off their obligations with a creditor of one of its members.[37] It is also for this reason that article 1347-6 of the Civil Code allows the surety to oppose payment of the debtor's debt by referring to another debt owed by the creditor to the debtor. However, the debtor may not set up the debt owed by the creditor to the surety in order to oppose payment.

35 ROUSSILLE (2001) 311. For a similar view see AUCKENTHALER (1996) para 5; BONNEAU (2017) para 933.

36 See DELOZIÈRE-LE FUR (2003) 59. According to Delozière-Le Fur, set-off extinguishes obligations owed between parties and creates the same juridical situation as if they had paid their dues. This author adds that sometimes set-off may also be considered as a security of payment and is considered as such especially in the settlement of payments in a payment system. *Ibid.* 39 & 59. Hubert states that whilst set-off was originally considered as a simplified means of payment, it may also be considered as a simplified means of enforcement of collateral for instance in relation to financial transactions regulated by article L.211-36 of the Financial Code. See Olivier Hubert, 'Chapter 14: France', in JOHNSTON *et al.* (2018), para 14.33.

37 DELOZIÈRE-LE FUR (2003) 70. Hontebeyrie states that the words used in the article 1347, namely that set-off is ('*est*') the simultaneous extinction of reciprocal obligations between two persons, indicates that reciprocity is consubstantial to set-off and therefore multilateral set-off does not exist or, to be more precise, does not emanate from the Civil Code. This is confirmed by the new article 1348-2 on conventional set-off which explicitly re-confirms the reciprocity requirement. See HONTEBEYRIE (2016) 154. It is also the case that what is referred to as multilateral set-off in French doctrine may be actually broken down into the settlement of bilateral transactions through, for instance, a central clearing house. See MATTOUT (2006) 165.

Contrary to the situation under English law, French law does not distinguish between insolvency set-off and other types of set-off. The former article 1289 of the Civil Code formally recognised only legal set-off which under article 1290 of the Civil Code applied as a matter of law even without the knowledge of the debtors,[38] whereas the new law recognises three types of set-off commonly referred to as legal, judicial and contractual set-off. In addition, under the new law, legal set-off needs to be invoked by the creditor in order to be effective and no longer operates automatically as a matter of law. It appears therefore that French law has moved away from the classical notion of the Roman *Corpus Juris* of '*ipso iure compensatur*' originally embraced by the Napoleonic Code. In terms of the classification established by Dalhuisen, the requirement of invocation results in a shift from set-off being a procedural tool under the old law to a mechanism becoming dependent on the will of the parties and thus subject to party autonomy.[39]

A similar view is expressed by Andreu who confirms that under the current law legal set-off has become a voluntary mechanism which requires a unilateral manifestation of the will of one of the parties to be effective.[40] It was explained in the Report to the President of the Republic on the Ordinance of 10 February 2016 that the amendment was introduced to put an end to an anomaly in the application of the law pointed out by a number of French jurists, in terms of which the courts required that set-off is invoked in order to be applicable even if its effects were automatic under the former article 1290 of the Civil Code.[41] Andreu criticises this view stating that it is surprising that the legislator refers to jurisprudence to justify this new requirement. He states that there is no judgment which indicates that set-off needs to be 'invoked', but it is rather the case that the judge could not raise the plea of set-off *ex officio* since it is not, under French law, a rule of

38 It is to be noted that although the former article 1289 of the Civil Code specifically provided for one type of set-off, namely the automatic set-off of debts which are certain, liquid and due, the court or the parties could intervene to modify these requirements, as will be seen later. The only requirement in respect of which no 'intervention' was allowed related to reciprocity which must be invariably satisfied for set-off to take place. See DELOZIÈRE-LE FUR (2003) 60; PICHONNAZ (2001) 516. According to Pichonnaz, set-off in this case has a constitutive effect, rather than an extinctive effect. *Ibid.* 17.

39 DALHUISEN (2019), Volume 3, 386.

40 ANDREU (2016) 89. Andreu states that this development was advocated by a number of French jurists such as Roger Mendegris, in *La Nature juridique de la compensation*, (L.G.D.J., 1969), Alexis Collin, in 'Du caractère volontaire du dèclenchement de la compensation', RTD Civ. 2010, n° 2 at p 229 and Jérôme François, in *Les obligations, Régime général*, Economica, 3e Edition, 2013, n° 75. *Ibid.*

41 Rapport au Président de la République relatif à l'ordonnance n° 2016-131 du 10 février 2016 portant réforme du droit des contrats, du régime général et de la preuve des obligations, JORF n°0035 du 11 février 2016. Although the French Code of 1804 envisaged the automaticity of set-off in the bilateral operations of two parties, the general interpretation of jurists of those times was that set-off had to be invoked in the courts in order for the judge to take cognizance of it. See PICHONNAZ (2001) 505. Pichonnaz himself confirms that set-off should depend on the will of the parties. *Ibid.* 510.

public order and hence it is up to the debtor who is being sued to raise it in defence. As a result, Andreu expresses the opinion that it is therefore not a procedural rule which has been sacrificed but a substantive one as a result of which set-off only produces extinctive effects subject to the condition that the debtor manifests the will to trigger it.[42] Hontebeyrie also criticises this new requirement which was a late insertion in the drafting proposal but states that it has not changed the extinctive characteristics of set-off. The reason for this is that in any case the law provides that the set-off operates not from the date of the invocation but retroactively from the date when all the requirements of legal set-off are met, indicating that the extinctive character continues to operate from this moment. According to this author, this indicates that although set-off is now conditioned by the invocation, it does not ensue from it.[43]

The invocation requirement is thus one 'new' requirement of legal set-off. The other requirements pertain to the 'traditional' concept of legal set-off provided under the former article 1289 of the Civil Code and reproduced in article 1347 of the Civil Code. Article 1347 provides that set-off is the simultaneous extinction of reciprocal obligations between two persons ('*l'extinction simultanée d'obligations entre deux personnes*') up to the lower amount and, subject to invocation, becomes effective on the date when all applicable conditions are fulfilled. Article 1347-1 of the Civil Code lists these conditions as referring to two obligations which are fungible, certain, liquid and payable ('*entre deux obligations fongibles, certaines, liquides et exigibles*'). The co-existence of these elements, together with the requirement of reciprocity, permitted the automatic operation of set-off under the former law since these were deemed typical characteristics of payment.[44]

The fungibility requirement gives rise to the extinctive effect and is a requirement that can be remedied by intervention since the French courts have long recognised valuation mechanisms agreed to by the parties in their agreements in order to give value to their obligations. For instance, whilst in the past it was not possible to set off monetary debts expressed in different currencies, it is now possible to agree on a technique to convert the amounts in the same currency. This possibility is now incorporated in article 1347-1 of the Civil Code.

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42 ANDREU (2016) 89.

43 HONTEBEYRIE (2016) 163. Hontebeyrie states that Pothier had already advocated against this voluntarist thesis, and was in favour of automatism, indicating that this argument had already been raised at the time of the drafting of the Napoleonic Code. *Ibid.* 164. With this requirement of invocation, French law, similar to German and Swiss law, creates what Pichonnaz calls a 'suspensive condition' ('*condition suspensive*') dependent on the will of the parties for the realisation of the extinctive effect of set-off. See PICHONNAZ (2001) 514.

44 DELOZIÈRE-LE FUR (2003) 60. Delozière-Le Fur makes a distinction between the requirements of certainty, liquidity and payability which are of the essence for payment, and the requirements of fungibility and reciprocity which are not required for payment but are necessary to render set-off a means of payment. *Ibid.*

The certainty requirement was not specifically mentioned in the old law and was included in the new article 1347-1 of the Civil Code to import a condition from jurisprudence whereby if a debtor claimed that his creditor owed him another connected debt, the debtor would be asked to prove the existence of the claimed debt. The certainty requirement therefore refers to the likeliness or proof of the existence of a connected debt.[45]

The liquidity requirement means that the mutual debts must be of the same kind, actual and ascertainable. Even though the debt has not been ascertained, it may still be taken into account in instances where the remainder of the debt has yet to be calculated or a court has still to make a definite order setting out the sum that is due. The set-off is then effective once the valuation can take place.[46]

Finally, a debt is deemed to be payable whenever the creditor has a right to immediate payment. A debt subject to a condition or a term that is not matured cannot be subject to legal set-off.[47]

In addition to the notion of legal set-off, the revised Civil Code also provides for the notions of judicial set-off under articles 1348 and 1348-1, and contractual set-off under article 1348-2. Judicial set-off may be pronounced by the judge even if one of the obligations, although certain, is not yet liquid and payable. Unless the judge decides otherwise, the set-off in this case is effective from the date of the decision. When these obligations are connected with each other, then the law states that the judge cannot refuse their setting off on the basis that one of the obligations is not liquid or payable. In this case the set-off takes place on the day when the first debt becomes payable.[48] According to the French Supreme Court (*Cour de cassation*), obligations are connected when resulting from the same contract[49] or when carried out pursuant to different contracts which constitute a single global business relationship arrangement.[50] In relation to contractual set-off, the parties are free to agree to extinguish all their reciprocal obligations, both present and future, through set-off. The set-off in this case takes place upon the date of the agreement or, in case of future obligations, on the date of their coexistence. Hontebreyie comments that the reference to reciprocal obligations indicates that the requirement of certainty of existence of the

45 HONTEBEYRIE (2016) 157.

46 *Ibid* 159.

47 Olivier Hubert, 'Chapter 14: France', in JOHNSTON *et al.* (2018), para 14.08. In terms of article 1347-3 of the Civil Code, when a grace period is given by the judge to the debtor, this is not an obstacle for the creditor to set-off that claim.

48 Hontebeyrie explains that although the judge will pronounce the set-off in principle in the circumstances mentioned by law, it will become effective once the liquidity and payability requirements materialise. HONTEBEYRIE (2016) 159.

49 Cassation commérciale, 12 December 1995, Bull. Civ. IV 293. According to Delozière-Le Fur, the effects of connexity are compatible with due observation of the condition of reciprocity in relation to the operation of set-off. See DELOZIÈRE-LE FUR (2003) 81; PELTIER (1994) 55.

50 Cassation commérciale, 5 April 1994, Bull. Civ. IV no 142 and Cassation commérciale, 9 May 1995, Bull. Civ. IV no 130.

debts is mandatory for conventional set-off. On the contrary, the requirements of fungibility, liquidity and payability may be dispensed with under contractual set-off. For instance, contractual set-off may be resorted to in the case of debts whose object is not fungible so that an 'artificial' contractual fungibility may be agreed upon.[51]

French insolvency law restricts the enforcement of set-off upon the insolvency of one of the parties since it is not generally in favour of the enforcement of contractual pre-insolvency rights.[52] Thus, whilst French law does not provide for the notion of mandatory insolvency set-off, article L.622-7, I of the Commercial Code protects set-off from the opening of insolvency procedures by exempting the set-off of connected claims arising prior to the observation period from the general prohibition of payment of pre-insolvency claims. Obligations arising after the judgment opening insolvency proceedings may be set off if this is necessary for the execution of the proceedings in terms of article L.622-17 of the Commercial Code. Pursuant to article L.622-24 of the Commercial Code, a creditor whose debt arose before the opening of insolvency proceedings must file a declaration of debt with the creditors' representative which should include the total amount due on the date of the judgment opening the insolvency proceedings. The French courts have held that a set-off may not occur if the creditor has failed to declare its debt in the insolvency process.[53] Thus, contrary to English law where insolvency set-off is considered a matter of public order and is mandatory, this is not the case under French law where set-off is considered a simplified means of payment and may even be renounced or, in the case of insolvency, not declared to the creditors' representative.

5.2.2 Insolvency Close-out Netting and Insolvency Set-off Compared

Since the concept of insolvency set-off does not formally exist under French law, a comparison between the concepts of *insolvency* close-out netting and *insolvency* set-off cannot, strictly speaking, be made. As a consequence, the comparison between these concepts in relation to French law will take place on two levels, first on the level of the relationship between close-out netting and the three types of set-off stipulated under the Civil Code, and secondly on the treatment of these concepts under the rules on collective proceedings.

A reading of French law and literature gives the impression that set-off is central to the netting mechanism under French law. Thus, the drafting of article L.211-36-1 of the Financial Code indicates that the determination of a close-out amount is based on the set-off methodology. Paragraph I of this article refers to financial obligations being terminated and the claims resulting from such termination being set off, resulting in a single amount. Paragraph II of the same article then provides that the modalities of termi-

51 HONTEBEYRIE (2016) 161.
52 Olivier Hubert, 'Chapter 14: France', in JOHNSTON *et al.* (2018), para 14.19 *et seq*.
53 Cassation commérciale, 15 October 1991, Bull. Civ. IV No. 290.

nation, valuation and set-off of obligations may be opposed to third parties and that any operation relating to termination, valuation or set-off carried out on account of civil enforcement proceedings or the exercise of a right to oppose is deemed to have taken place prior to such procedures, thus creating retroactive effects.

From the perspective of French doctrine, and consistent with the legal drafting of article L.211-36-1 of the Financial Code, the term '*résiliation-compensation*' coined by French authors to refer to netting is indicative of the approach that the close-out netting concept is considered a combination of two basic existing concepts under French law, namely termination (*résiliation*) and set-off (*compensation*).[54] This may also signify that close-out netting may have been, at least initially, considered as a simplified means of payment, although the positioning of article L.211-36-1 in the Financial Code under the heading of financial instruments ('*Les instruments financiers*') does not really justify this argument. The law itself does not use this term, or any other term to refer to netting, so that the term '*résiliation-compensation*' may in the end not be a legal term but a practical way for French jurists to refer to close-out netting for lack of existence of a technical term. In fact, in more recent literature, the terms 'netting' and 'close-out netting' in their English version are being widely used, possibly as a result of the fact that with experience gained in the use of this new mechanism, it is felt that the old term '*résiliation-compensation*' may not be adequate to describe the more complex steps involved in the close-out netting process.

Before proceeding to the comparative analysis of the constitutive elements of the two concepts, the following statements made by French jurists in relation to this comparison may help to set the scene for the more detailed commentary. Citing the old netting provision promulgated by the law of 31 December 1993, Peltier states that this law did not bring about any revolution in French law since the principle of conventional set-off did not raise any real uncertainties taking into account the favourable evolution of jurisprudence. However, Peltier admits that the law has provided statutory certainty to the set-off of claims in the financial markets. In addition, the law permits the setting off of different types of transactions and thus allows what he terms '*superglobalisation*'. According to this author, an important certainty brought about by netting law is to allow a party to lawfully terminate transactions in particular upon the occurrence of insolvency of the counterparty, consistent with the practice in financial markets to liquidate positions in case of a default by one of the parties.[55]

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54 According to Gaudemet, this term is preferable to the term '*compensation avec déchéance du terme*' (set-off with expiry of term) sometimes used since this presupposes that the contract under which the obligations arose remains current with the defaulting party only losing the benefit of the suspensive condition, leading to the immediate payability of its obligations. The contract is then extinguished prematurely due to the payment of the obligations. See GAUDEMET (2010) para 467.

55 PELTIER (1994) 56.

Caillemer du Ferrage states that the concept of close-out netting, composed as it is of a contractual mechanism permitting the termination of current contracts and the calculation of the economic value of the terminated transactions, is not set-off since set-off does not contemplate the termination of reciprocal obligations. According to him, close-out netting is more similar to a pre-established contractual method to determine the loss which may be suffered by one party in relation to unforeseen defaults by the other party.[56] This is also confirmed Gaudemet and Auckenthaler. The latter adds that the juridical nature of netting cannot be totally reduced to the notion of set-off as regulated by the Civil Code since it encompasses more juridical mechanisms, such as novation, to achieve a single amount due in relation to reciprocal claims by two parties.[57] Caillemer du Ferrage concludes that set-off is more similar to the notion of global netting which foresees the setting off of termination amounts due under different agreements to one single amount. In this sense, this author considers that global netting is truly a set-off mechanism as envisaged under French law.[58]

By way of preliminary observations, there seems to be a common understanding that there are significant differences between close-out netting and set-off, even though this may be less so in the case of contractual set-off. Whilst set-off is primarily a mechanism to extinguish reciprocal debts, close-out netting has been ascribed the characteristics of an indemnification mechanism which permits the termination and liquidation of positions of counterparties upon default, in line with practices applicable in financial markets.[59] It is understood (though not stated in the law) that close-out netting may involve mechanisms other than set-off to determine a final close-out amount, such as novation or replacement values. On the other hand, the set-off mechanism will invariably apply in the global netting of close-out amounts determined for different transactions or different agreements. Further comparative analysis of the two concepts is made below, with a view to assessing whether close-out netting can be considered as a contractual enhancement of set-off.

Scope of Application

On a statutory level, there is a difference in relation to the scope of application of the set-off and close-out netting regimes so that whilst set-off is intended to apply generally to all obligations, close-out netting is restricted to financial obligations. In terms of article 1347 of the Civil Code set-off is described as the simultaneous extinction of obligations which are reciprocal

56 CAILLEMER DU FERRAGE (2013) para 2.
57 GAUDEMET (2010) para 468; AUCKENTHALER (2001) para 3.
58 CAILLEMER DU FERRAGE (2001) 4.
59 This is confirmed in the ISDA French Law Opinion at p 11.

between two parties (*'l'extinction simultanée d'obligations réciproques entre deux personnes'*). There is no limitation on the type of obligations that may be set off so that even claims based on damages and tort may be included provided the obligations remain fungible, certain, liquid and payable. Given the practicalities of this concept as a means of payment, the concept has developed in a way that, either judicially or contractually, it is possible to set off even obligations which are not yet liquid or payable, provided they are connected[60] and are reciprocal.[61] In terms of personal scope, there is no restriction as to the type of parties who may benefit from set-off, so that these may be individuals, corporates or any type of entities. By contrast, under article L.211-36 of the Financial Code close-out netting rules apply in relation to financial obligations but which may vary in scope, depending on the nature of the parties. Thus, close-out netting is available in relation to financial obligations resulting from all types of contracts (*'tout contrat'*) giving rise to payment of cash or delivery of securities if both parties are eligible entities in terms of article L.211-36, I of the Financial Code, and in relation to financial obligations resulting from transactions in financial instruments listed in articles L.211-1 or L.211-36, II of the Financial Code if only one of the parties is an eligible entity. The more restricted material and personal scope is in keeping with the idea expressed earlier that the close-out netting mechanism is considered by some French authors as a form of indemnification which is typically available in the financial markets to cover for losses that may be suffered by financial market players on account of the default of their counterparties.

Basic Requirements

A number of conditions need to be fulfilled in relation to both the set-off and close-out netting concepts for these to be effective. First, it has been seen already that reciprocity of the obligations is a *sine qua non* for both concepts. Both concepts permit setting off claims which are non-fungible provided that the parties have provided the valuation of these claims in their pre-existing contractual arrangements in relation to close-out netting and contractual set-off, or if it can be determined through other means in relation to legal[62] and judicial set-off. The condition of certainty of obligations necessarily needs to be fulfilled in relation to both concepts, but whilst this may need to be proved in particular in relation to judicial set-off, in both close-out netting and contractual set-off the contractual mechanism will record the reciprocal obligations of the parties which are subject to the netting or set-off mechanism, thus satisfying this requirement. The law foresees the possibility in the case of judicial and legal set-off to allow set-off

60 See article 1348 of the Civil Code in the case of judicial set-off.

61 See article 1348-2 of the Civil Code in the case of contractual set-off.

62 For instance, see article 1347-1 of the Civil Code in relation to the fungibility of obligations expressed in different currencies.

even in respect of obligations which are not yet liquid or payable or in respect of future obligations, but in these cases the set-off occurs when these conditions have been met. In close-out netting, on the contrary, the parties may agree on modalities how to accelerate and terminate these obligations, thus bypassing the requirement of liquidity and payability.

Second, and following from the foregoing, the law on close-out netting permits the termination and closing out of outstanding transactions. Article 1347 of the Civil Code permits the setting off of obligations when all statutory conditions have been satisfied, implying that the obligations should have become payable. Exceptions apply in relation to judicial set-off where the set-off is effective from the date of judgment even if one of the debts is not liquid or payable or from the time when one of the debts becomes due in the case of connected debts.[63] However, these exceptions do not amount to termination as such of the pending obligations and in any case are not based on the contractual freedom of the parties but are determined by the judge presiding over the case. In fact, although the judge will declare the set-off applicable as stipulated by law, it can only become effective once the liquidity or payability materialises.[64] Under contractual set-off the parties are given the contractual freedom to set off present or future obligations, but this does not result in a termination and acceleration of outstanding obligations since the set-off can only take place once the future obligations coexist. On the other hand, article L.211-36-1 of the Financial Code recognises the contractual freedom of the parties to establish the termination modality and this is protected under the rules of collective proceedings. This freedom, as will be seen in the next part of this chapter, may now be curtailed by the implementation of bank resolution measures.

Third, netting under article L.211-36-1 of the Financial Code is operative at either one or two levels. In the first instance, there is netting in relation to obligations resulting from one agreement and, if global netting is applicable, in second instance there is set-off in relation to the close-out amounts derived under two or more distinct agreements. The set-off mechanism is, therefore, an intrinsic element of global netting. The set-off of amounts due under the various netting agreements to achieve global netting is possible if this has been specifically agreed to by the parties so that it is a contractually agreed set-off and not the legal set-off envisaged under article 1347 of the Civil Code. The relevant set-off clause may feature in each netting agreement concluded between the parties or in only one of the agreements which cross-refers to the other agreements. Alternatively, it may be included in a separate master netting agreement ('*une convention chapeau*') which specifically incorporates all the netting agreements concluded between the parties.[65] Set-off is also the mechanism applied when enforcing the

63 See articles 1348 and 1348-1 of the Civil Code.

64 See HONTEBEYRIE (2016) 159.

65 JURISCLASSEUR (2013) Fasc. 2050, para 86; LE GUEN (2001) 39.

collateral securing financial obligations under a close-out netting provision falling within the scope of article L.211-36 of the Financial Code. In this case enforcement takes place without the prior written notice of the other party and without court authorisation.[66]

Fourth, it has been stated above that following the amendments to the provisions on set-off whereby the automatic trigger of the set-off mechanism has been replaced by a requirement to invoke the set-off once all requirements have been fulfilled, the operability of legal set-off has become dependent on the will of the parties. In a sense, this has brought the concept of set-off closer to that of close-out netting which is typically also triggered by the notification of one of the parties in terms of the relevant agreement. A question which arises is whether the invocation requirement in relation to set-off has now affected the automatic trigger of the close-out netting provision sometimes made applicable under master agreements upon the insolvency of the counterparty. The possibility to apply the automatic trigger of close-out netting under certain master agreements has been expressly recognised.[67] It could be argued that since a close-out netting provision is regulated by the provisions of article L.211-36-1 of the Financial Code, the invocation requirement arising under a different provision of law in respect of set-off, namely article 1347 of the Civil Code, should not affect the automatic trigger of close-out netting provisions so long as these relate to financial obligations and fall within the scope of article L.211-36 of the Financial Code. The situation may be less clear in the case of global netting where the set-off mechanism applies to close-out amounts determined under different netting agreements. However, the same argument made above could also apply in this case in the sense that the applicable provision remains article L.211-36-1 of the Financial Code and it is this article, and not article 1347 of the Civil Code, which will regulate the global netting and any automatic application of it. As remarked above, the set-off mechanism used in global netting is not the legal set-off regulated under article 1347 of the Civil Code but is a mechanism foreseen in article L.211-36-1 of the Financial Code which may achieve the determination of a single close-out amount.

Collective Insolvency Proceedings

In terms of article L.622-7 of the Commercial Code pre-insolvency claims should be connected in order for set-off to be permitted following the commencement of collective procedures, otherwise they fall under the general prohibition of payment of pre-insolvency claims. It has been seen that for the purposes of set-off, claims are connected if they result from the same contract or are comprised in a global economic relationship. Post-insolvency claims may be set off if this is necessary for the continuation

66 Olivier Hubert, 'Chapter 14: France', in JOHNSTON *et al.* (2018), paras 14.14 & 14.32.
67 See ISDA French Law Opinion at p 10.

of the insolvency proceedings.[68] The question arises whether the same requirements need to be fulfilled in the case of netting agreements. Firstly, article L.211-36-1 of the Financial Code does not differentiate whether the obligations were entered into before or after the opening of insolvency proceedings. Secondly article L.211-40 of the Financial Code protects netting arrangements, including global netting arrangements, if these fall within the scope of application of article L.211-36-1 of the Financial Code. Bonneau *et al.* state that all that is required is for the transactions to be linked together to one or more master agreement or agreements.[69] Article L.211-40 does not impose any conditionality for the protection to apply, such as the lack of knowledge or constructive knowledge of the pending insolvency as was the case under English law.

The interrelation between set-off and close-out netting in insolvency proceedings is delineated by Gaudemet when he states that once the indemnity arising under the terminated contracts is liquidated in close-out netting, then the legal set-off of the liquidated amounts becomes effective since the reciprocal debts become liquid, fungible and payable, and thus fulfil the basic requirements of legal set-off. Gaudemet bases his argument on the old article 1290 of the Civil Code, cited in part 5.2.1 above, which provides that legal set-off '*a lieu de plein droit, par la seule force de loi, même à l'insu des débiteurs*'.[70] Even if for the moment the argument of the change in law requiring invocation is put aside, it is contended that this statement is incorrect. First, legal set-off under French law is not mandatory so that it does not necessarily apply if the conditions of set-off are met. It has been seen that even under the old article 1290 the courts required set-off to be invoked in order to be taken cognisance of and it could even be renounced by the parties. Second, close-out netting is based on party autonomy which is given statutory recognition so that it is more logical to interpret the set-off of liquidated amounts under close-out netting to be a reference to contractual set-off rather than legal set-off as has been done under English law doctrine. Indeed, the termination of contracts does not in itself include the valuation aspect thereof which can be undertaken more liberally under contractual, rather than legal, set-off. Finally, set-off is not the only modality which may be resorted to in order to achieve a single close-out amount. For instance, novation is another possibility. Thus, it cannot be stated that legal set-off will invariably apply once the transactions are terminated under close-out netting since this depends on the contractual modality selected by the parties for determining a single amount.

68 See article L.622-17 of the Commercial Code.
69 BONNEAU (2017) para 934.
70 Translated: 'has legal effect, by the sole force of the law, even without the knowledge of the debtors.' GAUDEMET (2010) para 470.

5.3 The Recognition of Close-out Netting Provisions Before and After the Adoption of a Bank Resolution Regime

French law on close-out netting pre-dates the enactment of the EU's Financial Collateral Directive and possibly for this reason is not tied to a financial collateral arrangement. Since its inception, the netting regime and consequential derogation from the law of collective procedures have been restricted to the financial sector. Initially, there were three separate close-out netting regimes. The regime which served as the basis for today's close-out netting provision is that emanating from a general rule of 1993 which provided the possibility for clearing houses and their members to carry out close-out netting in the futures market. French close-out netting law is one characterised by various changes. Only those changes relevant to the research question will be mentioned.

Three Netting Regimes

The first netting regime governed the securities lending market. Article 33 of the Act of 17 June 1987[71] permitted the termination and close-out netting of operations in securities lending. The law required that the close-out netting arrangement was made in accordance with the provisions of a market master agreement organising the relationships between two parties. There are no special conditions regarding the status of the parties. This was later codified as article L.432-8 of the Financial Code.

The second netting regime, and which later formed the basis for the single amalgamated netting regime, was regulated by the law of 31 December 1993,[72] introducing a new article 2 in the law of 28 March 1885 on the futures market ('*marchés à terme*') providing that the debts and credits relating to the futures market which conform to the regulations of the *Conseil des marchés à terme* or are governed by a master agreement conforming to the general provisions of the relevant national or international master agreement concluded by at least two parties, one of which is an eligible entity, may be set off according to modalities foreseen by such regulations or master agreement. If one of the parties is undergoing corporate restructuring or liquidation procedures, the termination of these transactions is fully enforceable. Four observations may be made. First, the derogation from collective proceedings is at this stage restricted to the futures market, possibly on account of the speculative nature of these contracts and the significant consequences that the insolvency of one of the parties could entail for the other party.[73] Although not expressly stipulated, there may already be primordial considerations of systemic risk in the mind of the legislator. Second, the rules of the relevant regulatory body of that market

71 Law no. 87-416 of 17 June 1987, subsequently amended by the Law of 2 July 1996.

72 See article 8 of Law no 93-1444 of 31 December 1993.

73 ROUSSILLE (2006) 399.

and of the terms of the master agreement which is based on the national or international standard agreement determine the modalities of termination and compensation. Thus, close-out netting modalities based on pure private agreements are not yet recognised so that modalities must conform to market regulations or market agreement standards. Third, it is envisaged that the master agreement is concluded between at least two parties ('*entre deux parties au moins*') which may imply that multilateral netting is possible. It is important to note that this terminology is used in the context of the futures market traded on an exchange and the reference to multiple parties may be more in relation to the fact that there will be multiple parties to such trading agreements rather than to the fact that the set off or netting as such will be multilateral, as opposed to bilateral. Fourth, the derogation applies only in respect of corporate entities which, as a rule, is in line with the type of transactions protected by the provision, namely futures, which are typically settled between corporate entities on a trade exchange. In the course of the modernisation of the financial activities, article 52 of the law of 2 July 1996[74] amended the 1993 provision and extended the scope of applicability generally to operations of financial instruments.

The third netting regime applied in relation to the repos market and was introduced by the law of 8 August 1994 which inserted an article 12 V in the law of 31 December 1993, stipulating a similar provision on close-out netting mechanisms for repos with the difference that the agreements had to be approved by the Governor of the *Banque de France* in his or her capacity as chairperson of the *Commission Bancaire*. This ensured that any derogation from the provisions of collective insolvency proceedings was subject to acceptable conditions.[75] There were also no particular conditions regarding the status of the parties. This provision was later codified as article L.432-16 of the Financial Code.

A Unified Regime

Article 52 of the 1996 Act applied to transactions relating to financial instruments which, although broadly defined, excluded spot transactions relating to assets other than securities, such as spot foreign exchange transactions. The close-out netting arrangement also had to comply with the framework of the regulation of the *Conseil des marchés financiers*[76] or the general principles of a national or international market agreement. Thus, whilst this provision extended the scope of application of financial instruments, it was still required that the modalities of close-out netting are subject to regulation

74 Law no 96-597 of 2 July 1996 (called Loi MAF, derived from its name '*Loi […] de modernisation des activités financières*'.

75 LE GUEN (2001) 42.

76 Now replaced by the *Autorité des marches financiers* (AMF) which is an independent authority and regulates participants and products in France's financial markets. See the website of the AMF at < http://www.amf-france.org>.

by market associations or to standard master agreements in order to benefit from the derogation of the collective procedures when terminating transactions. Article 52 applied to the extent that at least one of the parties was an eligible entity. Thus, it did not apply to a master agreement concluded between two unregulated entities such as commercial corporates.

This provision was later incorporated as article L.431-7 of the Financial Code,[77] the predecessor of today's article L.211-36-1, following the codification of various laws into the Financial Code in 2000[78] and included a slight widening in scope of application to include netting agreements concluded by public entities. Moreover, at the time set-off was permitted product by product since cross-product netting was still not permitted. The parties had to negotiate different agreements for each product even though the applicable agreements tended to provide for the same core provisions.[79] This situation brought increased risks in case of the insolvency of the counterparty which had implications for regulatory capital requirements. This state of affairs became difficult to explain and to justify[80] which led to the unification of the three regimes by the law of 15 May 2001.[81] This law extended the application of the former article L.431-7 of the Financial Code to cover also the set-off of securities lending and of repos, hitherto regulated under former articles L.432-8 and L.432-16, respectively, of the Financial Code.[82]

Global Netting

Former article L.431-7 of the Financial Code was amended on several occasions, each time serving to widen either the scope of its application or the scope for party autonomy. The more significant of these amendments regard the introduction in 2001[83] of global netting (*'compensation globale'*) in relation to financial entities, which at this point was restricted to setting off the close-out amounts calculated under two or more master agreements concluded between eligible parties provided the parties could create a link between these agreements. At this stage it excluded global netting of interbank loans and deposits.[84] In 2003[85] global netting was extended

77 See Ordinance No. 2000-1223 of 14 December 2000.
78 *Le Code monétaire et financier* annexed to Ordinance no. 2000/1223 of 14 December 2000 which entered into force on 1 January 2001.
79 ROUSSILLE (2001) 312; CAILLEMER DU FERRAGE (2001) 6.
80 LE GUEN (2001) 43.
81 Law no. 2001-420 of 15 May 2001 (called Loi NRE after its name *'Loi […] relatives aux nouvelles regulations économiques'*).
82 For a description of certain limitations applying in respect of repos and securities lending, notwithstanding this unification of regimes, see Auckenthaler (2001) paras 11, 12 & 15.
83 Article 29 of Law no. 2001-420 of 15 May 2001. Without these provisions, it is doubtful how a connexity could have been otherwise created between the agreements which would have satisfied the provisions of article 622-7 of the Commercial Code. See AUCKENTHALER (2001) para 18.
84 LE GUEN (2001) 45.
85 Article 39 of Law no. 2003-706 of 1 August 2003.

to situations where only one of the parties was an eligible entity. Further amendments were affected in 2005[86] by way of implementation of the EU's Financial Collateral Directive. This transposition led to an increase in the type of financial obligations that may be subject to close-out netting.[87] The law initially excluded from the benefit of this provision those agreements concluded between parties one of whom was a physical person, but covered agreements between an eligible entity and an unregulated corporate entity.[88] The close-out netting provision was no longer required to be governed by the regulations of the *Autorité des marches financiers* or be based on a national or international master agreement.[89] This implies that the parties could freely determine the terms and conditions of their rights and obligations in any type of contract. However, given that the standard master agreements are judicially tested as to their enforceability, it is assumed that the parties continued to model their private agreements on the basis of these master agreements for the sake of legal certainty.[90] As noted in part 5.1, the French legislator adopted a partial opt-out under Article 1(3) of the FCD in that if both parties were eligible, the provision extended to all contracts concluded between them for the settlement of cash or delivery of financial instruments so that netting was no longer restricted to operations in financial instruments.[91] On the contrary, where one of the parties is an unregulated commercial enterprise, the requirement remained that the obligations had to arise from operations on financial instruments concluded with an eligible entity.

By and large, former rules relating to close-out netting and global netting were retained,[92] although it has to be noted that global netting was not tied to a particular master agreement and was increased to cover also financial collateral besides financial obligations into what has been termed universal global set-off ('*la compensation globale universelle*').[93] This global netting has been safeguarded not only from the provisions of collective proceedings but, following the transposition of the FCD, also from executive

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86 Article 2 of Law no. 2005-171 of 24 February 2005.

87 For an explanation of the type of instruments which may be subject to netting following the transposition of the FCD into French law, see ELIET & GAUVIN (2005) 47.

88 JURISCLASSEUR (2010) Fasc. 1550, para 52.

89 ELIET & GAUVIN (2005) 47.

90 JURISCLASSEUR (2013) Fasc. 2050, para 79.

91 TERRET (2005) 52.

92 *Rapport au Président de la République relative à l'ordonnance no 2005-171 du 24 février 2005 simplifiant les procedures de constitution et de realisation des contrats de garantie finacière*, NOR: ECOX0400308P.

93 TERRET (2005) 52. This notwithstanding the rule under French law that collateral is considered ancillary to the main transaction and is not due on early settlement. Hence, collateral is not typically included in the set-off of obligations. The ancillary nature of collateral is also reflected in *Convention-Cadre FBF Relative aux Operations sur Instruments Financiers à Terme* of the Federation Bancaire Française. Clause 11.6 thereof (English version) provides that 'The Parties may agree at any time to grant or provide and potentially segregate, any security or guarantee in respect of all or any of the Transactions.'

civil procedure measures. The reference to collective proceedings was also extended to similar proceedings regulated by foreign laws.[94] The inclusion of physical persons originally removed in the February 2005 amendments was reintroduced a few months later.[95]

Former article L.431-7 of the Financial Code was deleted by article 3 of Ordinance No. 2009-15 of 8 January 2009 and replaced by article L.211-36-1 by means of article 1 of the same Ordinance. The main change resulting from article L.211-36-1 is the widening of the list of financial instruments that may be subject to a close-out netting provision by the addition of a new provision contained in §II of this article. Articles L.211-36 and L.211-36-1 have been amended on a few occasions, the latest being in 2019.[96] Every amendment to the close-out netting regime has served to widen the scope of application and scope for party autonomy, even though the concept remained firmly anchored to protect arrangements in the financial markets.

Two main derogations protect close-out netting provisions falling within the scope of article L.211-36-1. It has been seen in part 5.1 that article L.211-40 of the Financial Code provides that the law on collective insolvency proceedings falling under Book VI of the Commercial Code should not hinder, *inter alia*, the application of article L.211-36-1 on the enforceability of close-out netting provisions and rules on the compounding of interest in article 1343-2 of the Civil Code should not affect netting arrangements protected under article L.211-36 -1 of the Financial Code. Further protection is afforded by Article L.211-36-1, II, which provides that the contractual modalities of close-out netting are enforceable against third parties and gives retroactive effect to these modalities in case of action brought by third parties to oppose these modalities. According to Gaudemet, this derogation is meant to protect close-out netting from the so-called 'claw back rules' which are individual actions based on either executive title such as seizure orders or on precautionary title such as the *actio pauliana*.[97] In addition, given that there is no mandatory set-off principle under French law, any restrictions imposed by set-off law should not apply to close-out netting provisions regulated by article L.211-36-1, other than that the provision should regard only bilateral and reciprocal obligations.

Since these derogations are widely termed[98] and do not impose any conditionality, it might be assumed that the protection given to close-out netting provisions is extensive. To a great extent it is. However, since these derogations specifically target insolvency law and third party execution

94 ELIET & GAUVIN (2005) 47.

95 See article 31 of Law no 2005-842 of 26 July 2005. Under a previous version of this article L.431-7, article 2 of Ordonnance no. 2005-171 of 24 February 2005 had excluded physical persons from benefitting from the close-out netting regime when contracting with an eligible entity.

96 Article 77(V) of Law No. 2019-486 of 22 May 2019.

97 GAUDEMET (2010) para. 519.

98 With the exception of the derogation from the provisions of article 1343-2 of the Civil Code.

action, and since article L.211-36-1 of the Financial Code does not expressly protect close-out netting provisions 'in accordance with their terms', protection may not be available in respect of other measures which do not fall under the insolvency or third party civil action regimes. At least three such measures have been identified in doctrine. First, articles 1244-1 and 1244-2 of the Civil Code permit the judge to grant a grace period by postponing or scaling back a payment due for a period of two years. This measure, if applied, may affect the early termination mechanism of a close-out netting provision.[99] Second, the derogations also do not cover the third-party holder procedure under articles L.262 and 263 of the Book on Fiscal Procedures ('*Livre des procedures fiscales*') so that the risk exists that an amount which a creditor thinks it can use to set off amounts due by its counterparty is seized by the tax administrator under this procedure.[100] Third, the applicable derogations do not cover the conservatory acts that may be exercised under powers granted to the ACPR in relation to institutions falling under its supervision in order to protect the interest of consumers under article L.612-33 of the Financial Code. These measures may include the temporary suspension, restriction or prohibition of the free transfer of all or part of the assets of the supervised institution.

Another regime which has affected the enforceability of close-out netting provisions is the introduction of bank resolution law, aimed to give supremacy to the fulfilment of the objectives pursued by this law. Contrary to the other laws mentioned above which escape the specific derogations protecting the close-out netting regime, resolution law expressly addresses and modifies the application of the close-out netting regime.

Resolution Measures

The role of party autonomy in the enforceability of close-out netting arrangements has been significantly affected by Ordinance no. 2015-1024 of 20 August 2015, now codified in article L.613-34 *et sequens* of the Financial Code. This was preceded by Law no. 2013-672 of 26 July 2013 which established the first resolution regime based on the BRRD proposal being negotiated at the time. The 2013 law provided a few basic principles of the resolution regime and already incorporated rules on the temporary suspension of contractual or termination rights, bail-in, the no-creditor-worse-off principle, the rule against partial transfers in relation to close-out netting

99 Gaudemet, who is a proponent of this view, states that given that this is a rule of a public nature there is nothing in the law to stop the judge from applying it in relation to a termination or resolution clause. He considers that the fact that articles 1244-1 to 1244-3 of the Civil Code are referred to in article L.611-7 of the Commercial Code is not sufficient to consider that these are covered by the article L.211-40 derogation given that the award of a grace period is established by said articles of the Civil Code and it would be necessary to disapply the Civil Code articles for the derogation in this respect to be effective. GAUDEMET (2010) para 483 & 527.

100 *Ibid.* para 530.

arrangements and the non-trigger of termination clauses.[101] The report presented in parliament during the discussion of the 2015 Ordinance confirms that the latter law completes (*'reprend, complète et précise'*) the transposition of the BRRD originally initiated by the 2013 law and aligns it with the framework of the EU resolution mechanism, such as by removing internal domestic provisions which did not permit the recognition of foreign resolution measures.[102]

Current French resolution law imposes a number of restrictions on the enforceability of close-out netting arrangements. Most of these result from the transposition of the BRRD. Foremost among these is that parties cannot trigger the operation of close-out netting provisions following the exercise of resolution measures, if contractual obligations continue to be performed.[103] These restrictions apply taking into account a number of factors mentioned in article L.613-34-2 of the Financial Code which may indicate that the institution concerned is of systemic importance. The other restrictions are outlined below.

Bail-in

The resolution college of the ACPR is empowered under article L.613-55-6 of the Financial Code to exercise the bail-in tool in relation to financial contracts[104] and derivatives, and may for this purpose terminate such financial contracts or derivatives or liquidate their positions, except where these contracts have been exempted under article L.613-55-1 of the Financial Code.[105] Although close-out netting provisions incorporated in financial contracts have not escaped the bail-in provision, however some protection is afforded in relation to the valuation of the obligations. Thus, whilst in normal cases the valuation is calculated by an independent expert,[106] under

101 See in particular the former article L.613-31-16 of the Financial Code, which codifies in part the provisions of article 26 of the law of 26 July 2013 setting out the resolution regime.

102 *Rapport au Président de la République relative à l'ordonnance no 2015-1024 du 20 août 2015 portant diverses dispositions d'adaptation de la legislation au droit de l'Union européene en matière financière*, JORF nº0192 du 21 août 2015, page 14646 texte nº 18. See also BONNEAU (2015), comm. 166.

103 See article L.613-50-4 of the Financial Code. This rule is rendered mandatory in terms of the provisions of Article 9 of EC Regulation No. 593/2008. See also in this respect article L.613-56-3, III of the Financial Code in relation to the exercise of the bail-in tool, and article L.613-56-5, IV of the Financial Code, in relation to the suspension of termination rights.

104 A wide definition of financial contracts (*'contrats financiers'*) is provided in article L.613-34-1-12º of the Financial Code. This definition includes all types of contracts covered by the French netting regime.

105 Bail-in of financial contracts may be avoided if collateral is put in place and if transactions are entered into for less than seven days, what are termed as *'contrats à exécution successives'* or *'spontanés'*.

106 See article L.613-47 of the Financial Code.

article L.613-55-6 of the Financial Code the valuation must be in accordance with existing netting arrangements. This contrasts with the former article L.613-31-16, IV of the 2013 regime in terms of which valuation of obligations was based solely on expert valuation. In addition, under article L.613-55-6 of the Financial Code the respective obligations owed between the parties must be settled on a net basis as foreseen by the netting arrangements. In this way the close-out netting provision itself is protected and the bail-in provision is only exercised on the net amount determined as originally agreed by the parties.[107]

Temporary Suspension of Termination Rights

Article L.613-56-5 of the Financial Code empowers the resolution college to impose a temporary suspension on termination rights arising under contacts concluded not only by the institution under resolution but also by a member of the group of that institution whenever the institution under resolution has a connection with that contract as specified in article L.613-56-5, I of the Financial Code. In this case the law provides a safeguard to the extent that termination rights may continue to be exercised after the expiration of the period of suspension if, following a transfer of the contract, there subsists an event of default which may trigger the termination of the contract and the resolution college has not exercised the power to recapitalise it in terms of paragraph 1° of article L.613-55, I of the Financial Code. A counterparty may exercise rights of termination before the expiry of the suspension if the resolution college informs it that the contract concerned will not be transferred or that it will not be subject to recapitalisation measures. It may be noted that the law is not clear whether the suspension is solely tied to transfer measures or is of wider scope since the reference to transfer measures is only made in paragraph III of this article.

Partial Transfers

The resolution college may decide to transfer in one or more occasions all or part of the rights or liabilities of an institution under resolution to one or various acquirers under article L.613-52 or to a bridge institution under article L.613-53 of the Financial Code. In both instances, the law provides that notwithstanding any provision to the contrary, the contracts transferred will remain fully effective without any right of termination being exercised solely on account of said transfer. Safeguards are provided by article L.613-57-1 of the Financial Code in relation to the exercise of these powers, in terms of which netting and set-off arrangements cannot be the subject of

107 In terms of the ISDA French Law Opinion, in terms of a delegated regulation issued adopted by the European Commission on 23 March 2016 'if a liability is fully secured and governed by contractual terms that oblige the debtor to maintain the liability fully collateralized on a continuous basis […] it should be excluded from [bail-in].' *Ibid.* 60.

a partial transfer or be modified or terminated by the resolution college when exercising resolution powers in terms of articles L.613-56-2, L.613-56-3, II and III, and L.613-56-6 of the Financial Code, insofar as concerns the rights and obligations that may be set off or, following their termination, may be set off and converted to one single amount.[108] In order to guarantee the availability of funds in relation to insured deposits in terms of article L.312-4 of the Financial Code, the resolution college may by way of derogation of the above, transfer funds derived from a netting arrangement without transferring the other rights or obligations arising from the same contract or transfer, modify or terminate rights or obligations arising from such arrangements without transferring the funds derived from such arrangements.

5.4 Rationale of French Insolvency Law

The impact which the exercise of close-out netting rights has on the general principles of French insolvency law, including bank resolution law, will be analysed in this part of Chapter 5 with a view to analysing the resulting impact in the light of national insolvency law and state insolvency goals. This is preceded by a brief overview of the purposes aimed to be achieved by insolvency law.

Initially, the principal focus of the Commercial Code of 1807 was the body of creditors. From the moment of the opening of insolvency proceedings, the creditors lost the right to act individually against the debtor and could only notify their claims to the court so that distribution of proceeds was done on a *pari passu* basis. Certain privileged creditors such as holders of a specific security *in rem* remained outside the body so that these could enforce their rights on the insolvent debtor's estate. An important turning point took place under the law of 13 July 1967 which provided that secured creditors had to have their claims verified. Further changes in objectives were made by Law no. 85-98 of 25 January 1985 where the law placed the rescue of the business at the forefront of its concerns and abandoned the notion of the body of creditors so that secured or unsecured creditors were treated without distinction, resulting also in a serious deterioration in the position of holders of securities *in rem*.[109] The Act of 26 July 2005 strengthened this stance by the introduction of the safeguard procedure which took place earlier in time than the older proceedings of reorganisation and

108 Under article L.613-56-2, I of the Financial Code collateral securing a transfer may not be separated from the transaction when a transfer is made.

109 Hervé Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', in RINGE *et al.* (2009) 161. Synvet notes that this deterioration in the rights of secured creditors gave rise to a controversy on the constitutionality of the reform. *Ibid.* See also Decision 84-183 DC of the Constitutional Council, 18 January 1985 where the Court dismissed the complaint of retrospective effect of the Act on mortgages.

winding-up. The introduction of the accelerated financial safeguard procedure in 2014 further adapted the safeguard procedure for use by debtors in the banking and financial sector who were undergoing a conciliation procedure. Similar to the safeguard procedure, it also draws on the practice in the US and UK with regard to the pre-pack procedures and is characterised by the more concise timeframe within which the procedure is concluded. All this shows a clear tendency to have in place more expedient options and solutions to handle enterprise difficulties.

The prohibition of the individual pursuit of credit claims introduced in the 1980s significantly enhanced the rescue culture since it permitted a debtor in financial difficulties to propose and implement a plan to restructure its business. Thus, in the reform of 1985, article 1 provided that the aim of the Act was firstly to save the enterprise, secondly to protect employment, and thirdly to pay creditors. Under more recent amendments, in particular those instituted by Ordinance No. 2014-326 of 12 March 2014, this order was modified, so that the objectives of the new law were stated to be first to facilitate the anticipation of the aggravation of financial difficulties, second to enforce expedient procedures to deal with creditors, the debtor and associated entities and finally to take into account irremediable situations insofar as they effect rights of creditors and of the debtor and for this reason to put in place a procedure which is secure, simple and efficacious. Thus, although a slight amelioration in the plight of creditors can be detected, modern French insolvency proceedings continue to evolve around the enterprise and not around the payment of creditors, and for this reason the proceedings in place are more of an economic, rather than egalitarian, nature.[110]

The derogation given to protect the enforceability of close-out netting is clearly an exception to both the concepts of the *pari passu* treatment of the body of creditors and the idea of restructuring or rescuing the failing enterprise. The individual action taken by netting creditors could frustrate the effectiveness of safeguard proceedings initiated at a time when the debtor is not yet in a state of cessation of payments and therefore when obligations can still be performed. Indeed, the simple fact that a type of safeguard proceeding has been instituted is typically sufficient to trigger the close-out netting provision of standard master agreements and to lead to the exercise of termination rights. This preference given to netting creditors has a link with the legislative movement commenced in 1987 and pronounced more recently with the implementation of the EU's FCD to give special protection, and hence more rights, to creditors in financial operations. The realisation that overriding interests need to be protected in the enforcement of resolution measures in relation to banks and investment firms led to the containment of the exercise of netting rights, although, as has been seen,

110 See *Rapport au Président de la République relative à l'ordonnance no 2014-326 du 12 mars 2014 portant réforme de la prévention des difficultés des entreprises et des procédures collectives*, JORF n°0062 du 14 mars 2014, page 5243 text n° 2.

a number of safeguards were also implemented so as not to prejudice the netting creditor unduly. But these considerations are only made in relation to two types of institutions that may be particularly susceptible to systemic risk, namely banks and investment firms. For the other institutions, the 'old' regime applies and netting creditors are free to exercise their netting rights notwithstanding any rule of French insolvency law.

5.4.1 Principles Upheld by French Insolvency Law

In this part, the interaction of the role given to party autonomy in close-out netting provisions is examined in the light of the fundamental principles of French insolvency law related to pre-insolvency contractual entitlements, which are considered more relevant for this analysis. Arguably two of the more important principles upheld by French insolvency law in this scenario, and which have been briefly alluded to earlier in this chapter, relate to the continuation of contracts and the stay of individual action, both intended to facilitate the safeguard or restructuring of the enterprise in financial difficulties, or its orderly liquidation. A brief explanation of each principle is made initially, followed by an understanding of the impact of the enforceability of close-out netting provisions on these principles.

Principles

In relation to the principle of continuation of contracts, article L.622-9 of the Commercial Code provides that the activity of the enterprise continues during the period of observation. This is based on the understanding that the restructuring of an economic entity may not be feasible unless it continues trading. In order to give force to this rule, article L.622-13 of the Commercial Code provides that the administrator may demand the pursuit of contractual relationships by forcing the other party to perform its obligations notwithstanding that the debtor was not performing its obligations prior to the opening of insolvency proceedings and provided the administrator has sufficient funds to execute the delivery or payment promised by the debtor. In case of non-payment, the contract is terminated by operation of the law. The contract may also be terminated by the judge upon the request of the administrator if this is necessary for the rescue of the debtor and does not excessively affect the interests of the creditor. This principle applies to both the restructuring and safeguard proceedings and is a form of cherry-picking recognised by French law, although some level playing field has been incorporated in the law.[111] A similar procedure applies in relation to judicial liquidation in article L.641-11-1 of the Commercial Code. Financial collateral arrangements and operations relating to financial instruments

111 SAINT-ALARY-HOUIN (2013) 360.

totally escape the application of article L.622-13 of the Commercial Code in terms of article L.211-40 of the Financial Code.

The rule on the stay of individual creditor action is set out in article L.622-21 of the Commercial Code which prohibits the continuation or initiation of enforcement proceedings taken by creditors. As a result, whilst the contracts are expected to continue during the observation period unless they are detrimental to the interests of the debtor, creditors are obliged to suspend any rights of pursuit for payment or for enforcement of other rights. A distinction has traditionally been made between creditors whose claims originated prior to the opening of insolvency proceedings and those whose claims originated after the judgment opening insolvency proceedings.[112] Until the Act of 26 July 2005, only the *prior creditors* were subject to the constraints of the proceedings. They were grouped together in the general body of creditors into an entity which was given legal personality and which made it possible to treat them in the same way. To share in the distributions, prior creditors were required to declare their claims within strict time limits. Conversely, *subsequent creditors* retained their rights as if the debtor was not in financial difficulties. The reason for this was that the rescue of business could not be contemplated if trading could not be financed after proceedings were opened. Thus, as a general rule, subsequent creditors remained free to secure their credit and to have the charged assets sold in accordance with the terms of their arrangements. This distinction was partly undermined by the Act of 26 July 2005 whereby protection for subsequent creditors was only made available to creditors who *stricto sensu* financed the activity of the business. As a consequence, the subsequent creditors were made virtually subject to the constraints of the proceedings. In particular, they had to declare their claims if they wished to share in the distributions. Under the current article L.622-21 of the Commercial Code the stay is imposed on claims arising both before and after the judgment opening insolvency proceedings except those considered privileged in terms of article L.622-17 of the Commercial Code. These are debts originating regularly after the opening of insolvency proceedings for the purposes of the same proceedings or of the observation period, or which have been entered into for the benefit of the debtor during the said period. These are paid either as they become due or are given privileged status in an eventual distribution. This strengthening of the stay of individual action represents a change in approach and renders possible the determination of the financial state of affairs of the debtor in order to facilitate the elaboration of a plan of safeguard or rescue.[113]

112 THÉRY (2009) 12.
113 SAINT-ALARY-HOUIN (2013) 428.

Impact of Close-out Netting

As reiterated above, article L.211-40 of the Financial Code excludes close-out netting provisions regulated by article L.211-36 *et sequens* of the Financial Code from the law on collective proceedings. Synvet questions how can a system which puts emphasis on rescuing enterprises in difficulty be reconciled with the favourable treatment given to certain creditors and whether it is truly the case that only considerations of general interest have led to the law of collective proceedings being set aside or whether such considerations have sometimes served as a cover for the promotion of self-interest by the financial sector.[114] Former French law permitted, as a general rule, the settlement of obligations arising after the opening of collective proceedings on the understanding that continued trading by the failing enterprise is necessary for its rescue. This approach may help to explain the apparent lack of, or little, concern expressed by French jurists on the impact of close-out netting on the principle of *pari passu* and on the existence of actual or constructive knowledge of the impending insolvency. It may thus be the case that French jurists are 'accustomed' to the legal situation where subsequent creditors, including those whose rights arise after the opening of collective proceedings, are given prior rights for payment and the preferential rights given to the netting creditors may be just one other preference given to the detriment of the *pari passu* principle whose effectiveness was already significantly diluted by law. Although the scope of the principle of favouring subsequent creditors in terms of article L.622-17 of the Commercial Code is today substantially curtailed, it does not appear to have affected the application of the general derogation given by article L.211-40 of the Financial Code to close-out netting provisions, since the law does not distinguish whether the obligations arose before or after the opening of collective proceedings.

Another factor which could have contributed to this approach in relation to the *pari passu* principle is that the protection of creditors' rights is not the primary aim of modern collective proceedings laws. The primary aim is in most cases the rehabilitation of the debtor. Observance of the principles of continuity of contracts and of the stay of individual creditor actions are in fact intended to protect the debtor, at times to the detriment of the creditor. Thus, other reasons need to be sought to help explain why close-out netting arrangements concluded within the ambit of the financial sector are given a full exemption from the collective proceedings regime, thus prejudicing the rights of other creditors and reducing the chances of rescuing the failing enterprise. Even the reverse situation operating under bank resolution law, whereby restrictions on the exercise of close-out netting rights are reinstated, aims to give preference to the social and economic factors linked to

114 Hervé Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', in RINGE *et al.* (2009) 175.

the financial sector by protecting the critical functions of banks and investment firms, financial stability and the assets of their clients. Conversely, if this reversal negatively affects the orderly functioning of the market, it is the protection of the close-out netting provision that again prevails in order to ensure the stability of the financial sector against systemic risk. An understanding of the rationale for the preferences given to financial sector creditors and their netting arrangements may be sought by reference to the state goals which typically shape exceptions to general rules and by the economic dynamics which have been attributed to French commercial law. This aspect will be considered in more detail in the next part of this chapter.

5.4.2 Effect of State Goals on French Insolvency Law

Referring to the various changes to French law on collective proceedings, Omar views this as 'a constant, but somewhat vain, attempt to find the right solution'.[115] A different viewpoint is expressed by Saint-Alary-Houin who considers these changes as a trajectory course of French insolvency law to affirm the primacy enterprise rehabilitation whereby insolvency procedure is translated in terms of the enterprise and not of its creditors.[116]

Arguably, the principal aim of French insolvency law is still nowadays to save the business with a viable and sustainable solution, although more recent amendments have tended to strengthen creditors' rights generally, especially in safeguard proceedings as regards formulation of a restructuring plan agreed with creditors. At the turn of the millennium a clear choice was made by the French legislator to consider importing foreign insolvency-related structures into French law. This is reflected in an address delivered by the former President Sarkozy in 2007 at the Paris Commercial Court to commemorate the bicentenary of the Commercial Code, where he declared that commercial justice should first and foremost be at the service of the dynamism of the French economy ('*la justice commerciale doit être d'abord au service du dynamisme de l'économie française*').[117] Specifically in relation to collective proceedings, President Sarkozy required further amendments to be inspired by the US Chapter 11 model so as to encourage entrepreneurs to further develop initiative and the taste for risk.

As a result of this public policy, French law, which is based on the civil law heritage and is traditionally pro-debtor, has nowadays incorporated legal devices into its commercial law from common law (or hybrid common law) jurisdictions such as the UK and the US. Omar remarks that in the reforms commencing from 2005 the French legislator embarked on

115 OMAR (2014) 220. It may be argued that it is difficult for the legislator to make the right choice if the same collective proceedings apply to both corporate and individual debtors, given the different perspectives which need to be covered.

116 SAINT-ALARY-HOUIN (2013) 34.

117 Speech by former President Nicolas Sarkozy, *Allocution à l'occasion du bicentenaire du Code de Commerce*, Tribunal de commerce de Paris – 6 September, 2007.

a process of comparing French laws to those in other jurisdictions and adopting foreign law structures insofar as these were perceived to have been successful for the economy.[118] Saint-Alary-Houin, on the other hand, believes that the impetus to change started with the implementation of the EU's Insolvency Regulation in 2000 which regulated cross-European insolvency proceedings since it was recognised that French insolvency law had to develop in line with other European laws. Since this Regulation provided for both primary and secondary proceedings, it was considered that this would lead to forum shopping and in this scenario it was felt that French law should not be more penalising or stigmatising than the law of other member states. This background and the changing economic environment led the French legislator to make the necessary legislative changes to adapt to this new context.[119]

Considering the particular situation of the development of the French netting regime, the tendency for French law to be conservative is evident in the way in which it initially implemented the EU's Financial Collateral Directive. Thus, the latter gives a very wide definition of the obligations that may be secured by a financial collateral arrangement, namely obligations 'which give a right to cash settlement and/or delivery of financial instruments'[120] and which is applicable to arrangements between public or regulated institutions and 'a person other than a natural person, including unincorporated firms or partnerships'.[121] On the other hand, under French law the largest category of financial obligations that may be secured by a financial collateral arrangement, namely that covering any settlement, applies only to contracts concluded between institutions in the financial sector.

On the other side of the coin, Synvet criticises even the more restricted protection given by French law to financial arrangements concluded between a regulated entity and a corporate. He states that the main reason for the derogations of the FCD relates to the systemic risk which parties to a financial collateral arrangement may be exposed to if the close-out netting provision is not enforceable following the insolvency of one of the parties. This justification is absent where the arrangement is with a corporate, or at best will depend on the circumstances such as the size of the company in question, the amount of the liabilities undertaken, the number of transactions concluded, *etc.* Synvet further considers that whilst it is the case that French law reserves preferential treatment for transactions in financial instruments and not ordinary loans, still banks can relatively easily restructure their financial operations to fall within the ambit of article L.211-36 of the Financial Code, such as in the form of prepaid futures contracts, and concludes that this is a matter of 'giving French banks a competitive

118 OMAR (2011) 263.
119 SAINT-ALARY-HOUIN (2013) 52.
120 See Article 2(1)(f) of the FCD.
121 See Article 1(2)(e) of the FCD.

advantage in international competition, even at the price of sacrificing the interests promoted by the law of businesses in difficulty'.[122]

This dilemma is reflected in the debate of the French parliamentary Senate at the time when global netting was originally introduced into French law and was restricted to regulated institutions. This restriction on the nature of the parties was not included in the original version of the proposed law. In the end it was restricted since it was considered unfair to the other creditors to extend it to any type of creditor benefiting from close-out netting arrangements.[123] Roussille states that this helps maintain an equilibrium between the economic imperative justifying a derogation from the law of collective proceedings and the will to maintain the principle of equality of treatment of creditors in the non-financial world. Thus, banks and other financial institutions were under former law not allowed the privilege of entering into derivatives with persons external to the financial world and having these protected under global netting. Roussille, however, notes that it is probably when contracting with these entities, who are not constrained by any prudential rules, that banks and other financial institutions face the greatest risks since the former are not subject to any regulatory restriction.[124] Roussille further remarks that the French legislator has to be aware of what its neighbouring legislators are doing since if, for instance, German law allows global netting to all creditors, it would be necessary for the French legislator to be more liberal for the financial professionals.[125] In fact, today article L.211-36-1 of the Financial Code has opened the applicability of global netting also to persons, including physical persons, entering into netting arrangements with eligible entities.

One trend which has been consistent throughout the various reforms of the French close-out netting regime is the general liberalisation of this regime. As pointed out by the French authors cited above, this process is arguably in the direction of bringing French law in line with developments in other jurisdictions. It will be observed in the concluding part of this chapter that in so doing the French legislator may not have adequately put in balance the various interests affected by the close-out netting regime. This is evident in the absolute, 'condition-free' protection given to close-out netting arrangements from the application of the law on collective proceedings, save for those restrictions introduced in view of the transposition of the BRRD. The 'taste for risk' developed by the French legislator in line with public policy direction may put into question the consistency of this regime

122 Hervé Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', in RINGE *et al.* (2009) 179.

123 For a detailed analysis of the parliamentary debate on the global netting proposal, see CAILLEMER DU FERRAGE (2001) 7.

124 ROUSSILLE (2001) 313. Although, it may also be remarked that banks and other institutions will, in normal instances, be in a stronger bargaining position and should be able to protect their interests in other ways, such as by asking for collateral or reflecting their risks by charging higher interest rates.

125 *Ibid.* 315.

with protection given to the enterprise which is characteristic of French insolvency law.

5.5 Preliminary Conclusions

It is difficult nowadays to decide whether the French netting regime may be classified as liberal or conservative. On the one hand, its scope is more restrictive than that of the FCD since the French legislator opted out partially under its Article 1(3). The French legislator also did not incorporate into the law the FCD standard that close-out netting provisions are enforceable 'in accordance with their terms', which would signal the supremacy given to party autonomy in the recognition of close-out netting provisions. On the other hand, the partial opt-out is extended to include also physical persons, and the law allows the parties total freedom to agree on the modalities of termination, valuation and set-off of their close-out netting arrangements which, when taking into account that these three elements in fact constitute the close-out netting mechanism, is essentially equivalent to the FCD standard of enforcing close-out netting provisions 'in accordance with their terms'.

Originally developed as an offshoot of the termination and set-off ('*résiliation-compensation*') concepts, legislation on close-out netting arrangements under French law was adopted earlier than the EU's Financial Collateral Directive. It can thus be said that under French law the regulation of close-out netting is 'home-grown' but also incorporates characteristics which, as stated above, are not different from those of the FCD. Initially, the law regulating close-out netting did not recognise full contractual freedom in bilateral relations since the close-out netting provision had to be based on the applicable framework rules of the relevant market association or on international or national market standard agreements. At this stage, this amounted to self-regulation by the market which was granted recognition by law. In relation to the repo market, the parties were even required to obtain the clearance of the central bank Governor as chairperson of the *Commission Bancaire* prior to operating their close-out netting arrangement.

A process of successive amendments to the law led to its gradual liberalisation. At first, the close-out netting provision operated product by product, based on the set-off requirement of connexity between the obligations being netted. As a result, three different regimes existed for the regulation of different products. This segregation was later questioned as it did not serve any purpose related to close-out netting as a concept and this led to its gradual liberalisation from the constraints of both the set-off requirements as well as of the frameworks of market associations. The three regimes were thus amalgamated, and conditions began to be standardised and liberalised. Global netting was recognised and legislated upon specifically, though initially a contractual link between the obligations had to be established for global netting to be effective, reminiscent of the connexity requirement of set-off. Nowadays article L.211-36-1 of the Financial Code recognises the total freedom of the parties to determine the mechanisms for the termination, valuation and determination of a net amount in their contractual arrangements, the only restrictions being that the applicable agreement has to fall within the scope of application of article L.211-36 of the Financial Code. The link with set-off continued to diminish and connexity between obligations which are netted is no longer so restrictive.[126] Indeed, given the invocation requirement imposed on set-off, it is arguable that for agreements qualifying under article L.211-36 of the Financial Code, the parties can opt to enforce their netting rights rather than invoke set-off, not only in cases where set-off conditions are not met such as in relation to the connexity requirement, but possibly also when they are met, given that set-off is not a mandatory principle under French law.

First Sub-question

It has been noted that the reference to set-off (‘*compensation*’ or ‘*compensables*’) in article L.211-36-1 of the Financial Code is *prima facie* central to the regulation of close-out netting. But as noted above this reference has not restricted the pace for the contractual enhancement on which the close-out netting concept is based. Thus, the original notion of close-out netting was founded on the existing concepts of termination and set-off. With the further liberalisation of this concept, the ties with set-off are nowadays more limited, these being the reciprocity requirement and the fact that set-off is the modality used to determine a single amount in the case of global netting. Thus, beyond the requirement of reciprocity, the type of contractual enhancements permitted by French law in the recognition of close-out netting provisions leads to the preliminary conclusion in relation to the first sub-question of the Introduction that French set-off rules have not, generally speaking, influenced the more recent development or the interpretation of close-out netting rules.

Close-out netting bears the closest affinity with the concept of contractual set-off. Both regimes appear to allow the parties significant discretion to set the terms of valuation of obligations, and both seem to contemplate the possibility of compensating with future obligations. However, contractual set-off lacks the three-step process which constitutes close-out netting. Thus, termination rights are enforceable only in relation to close-out netting provisions, since under contractual set-off future obligations need to materialise before set-off can be effective. Likewise, the law on contractual set-off does not specifically recognise the discretion of the parties to consider different permutations in achieving a single net amount. The law on close-

126 This is confirmed in the ISDA French Law Opinion where it is stated that the close-out amount may include ‘termination values of different types of transactions, taken either separately or as a portfolio, whether cash or physically settled, and different currencies related or denominated products […]’. See ISDA French Law Opinion at p 11.

out netting, on the other hand, gives full freedom to the parties to establish ways how to determine the close-out amount. Set-off is one of these ways. Other possibilities include the novation of old obligations into a single new obligation owed by one party to the other, or the replacement value of the outstanding obligations. These options are not contemplated under the law regulating set-off, though mechanisms such as novation may derive from other provisions of French law.

Another significant departure from set-off is that the close-out netting process goes beyond the payment functionality attributed to set-off and includes the termination and enhanced valuation mechanisms exercisable on the basis of contractual arrangements. These contractual enhancements of the close-out netting principle have resulted in the creation of a loss indemnification mechanism which, except for the reciprocity requirement, is not tied to the fulfilment of the requirements of set-off and which is fully protected from the law of collective proceedings without the need to establish connexity (as required for set-off) between the various obligations. The only requirement to be met is that the various obligations are linked to the close-out netting provisions by a contractual provision.

Second Sub-question

As a preliminary conclusion to the second sub-question, it is deemed that French insolvency law has not affected the recognition given to close-out netting provisions. Thus, article L.211-40 of the Financial Code exempts close-out netting provisions from the provisions on collective proceedings without imposing any conditions similar to those of Article 8(2) of the FCD relating to the lack of actual or constructive awareness of the impending insolvency.

Perhaps because it is fundamentally a pro-debtor jurisdiction, there is no strong sentiment among French authors on the preservation of the *pari passu* principle. This may have led to the unexpected result that the liberalisation of the close-out netting concept was not met with significant controversial debate, at least in relation to the *pari passu* principle. Indeed, in the environment whereby in the 1980s creditors' rights were being significantly restricted, the reverse situation whereby the rights of a particular class of creditors, namely those with close-out netting rights, were given preferential rights would not have caused significant debate from the point of view of the *pari passu* principle which, in any case, was secondary to the principal aim of enterprise rescue.

The French legislator provided broad derogations from insolvency law and third-party action in articles L.211-40 and L.211-36-1, II respectively of the Financial Code. However, other laws not captured by these derogations such as the law on conservatory measures adopted by the ACPR under article L.612-33 of the Financial Code continue to apply. Thus, whilst the French legislator was liberal in the derogations granted under two specific regimes (*i.e.* insolvency law and civil execution action), no consideration seems to have been given to other regimes which could affect the recognition granted to close-out netting. Indeed, contrary to English law which has a strong tradition of protecting pre-insolvency contractual entitlements, the general understanding is that French law would not consider such entitlements favourably under general law and the application of these laws may ultimately affect or even prevent the enforceability of close-out netting provisions.

Third Sub-question

Insofar as concerns banks and investment firms, the enactment of resolution law also brought some modifications in the enforcement of close-out netting provisions. There is a close similarity with the restrictions imposed under the English resolution regime, also considering that ultimately both the French and English regimes had to adhere to the EU's BRRD. Thus, also affected by the French regime is the exercise of termination rights. First, termination rights cannot be triggered solely by the exercise of resolution measures if payment and delivery obligations continue to be performed. Furthermore, resolution law also imposes a suspension on termination to allow for the effective imposition of resolution measures, in particular in relation to the transfer of contracts. In the case of bail-in of financial contracts or derivatives, the resolution college is empowered to itself exercise the right of termination in order to proceed with the liquidation of outstanding transactions. On the other hand, a number of safeguards have been implemented to protect the close-out netting mechanism. Thus, termination rights can only be suspended if obligations continue to be performed. The contractual valuation methodology is to be respected by the resolution college when exercising the bail-in tool, so that this can only be exercised in relation to net amounts, rather than single transactions. There can be no partial transfers which could dismember the netting mechanism and any decision to suspend the termination of netting agreements has to take into account the orderly functioning of the market. There are evidently a number of interests that have to be taken into account and which are being balanced out. At all times, however, the close-out netting mechanism itself remains intact (even if its application is postponed or some elements of it are enforced by the resolution college rather than the solvent party), so that an amount of protection has been given even in the ambit of public policy regimes such as the resolution regime.

The regulation of close-out netting provisions and the restriction of the scope of regulation to the financial sector has existed in its basic form since 1987 but has since been gradually liberalised. It can be surmised that this is a case where the French legislator emulated foreign systems in developing this concept, and, in addition, the legislator seemed willing to go a step further and not require that the close-out netting provision forms part of a financial collateral arrangement or impose any conditions for the applicability of the derogation from the law on collective proceedings. French law therefore has a dedicated close-out netting regime which would presumably render the French jurisdiction more competitive in terms of other jurisdictions which have implemented the FCD more faithfully. This may result in France having gone even further than other jurisdictions to liberalise the close-out netting regime and may have earned the classification of being relatively liberal in this respect.

6 Insolvency Close-Out netting under US Law

6.1 Overview of the Regulation of Insolvency Close-out Netting under US Law

The US legal system has been described in the Introduction as an eclectic system which was historically influenced by both the common and civil law regimes. Based solely on considerations of its legal heritage, it is expected that the US regime will not be as liberal and pro-creditor as the English regime in the safeguarding of pre-insolvency contractual entitlements. On the other hand, it may well not be as restrictive as French law with its pro-debtor tendency instituted by the Code Napoleon and stricter approach on pre-insolvency contractual claims. It is presumed that as a hybrid system US law will adopt a more balanced approach towards the recognition given to close-out netting provisions.

In reality, the application of US law is not as straightforward as in the case of the other two national law systems analysed in this research. This is because US law is based on the dual application of federal and state laws so that areas of law such as insolvency proceedings, insolvency set-off and insolvency close-out netting may be regulated by two complementary regimes. As a result, this may distort the expectation that US law is reflective of a hybrid system when compared to the English and French systems given that the recognition of contractual rights may, to a greater or lesser extent, depend on the particular applicable state law and its common or civil law origin.

It is not intended in this chapter to analyse insolvency close-out netting under the various state laws, unless this is by way of example to illustrate an argument being made. The focus will be on US federal law and on the approach adopted by the legislator under US federal law when dealing with the recognition of party autonomy. The reason for this is that federal law sets mandatory rules having nationwide effect. Indeed, state laws apply to the extent that mandatory federal rules do not provide otherwise. Thus, whilst contractual rights are at first instance established and regulated by state law, federal law may impose restrictions or conditions on the exercise of those rights recognised by state law. This is certainly the case in relation to insolvency law and insolvency proceedings where, as will be seen below, rights recognised under state law are applicable within the confines set by federal law. Consistent with the previous two national law chapters, a brief overview is made initially of the interaction of US federal insolvency rules and applicable resolution regimes with the recognition of close-out netting provisions.

Insolvency Rules

In the US the term 'bankruptcy', rather than insolvency, is used to refer to formal insolvency proceedings. There are two main avenues under US law for addressing the situation of a bankrupt debtor. It may be reorganised or liquidated under the Federal Bankruptcy Code[1] (the Bankruptcy Code or the Code) or, where applicable, resolved under one of the special resolution regimes reserved for handling the insolvency of regulated financial entities such as insured depository institutions (*i.e.* banks) and systemically important non-bank financial institutions.[2] The Bankruptcy Code has been generally described as 'pro-debtor, with some exceptions'.[3] Chapter 11 of the Bankruptcy Code regulates reorganisation proceedings concerning corporations, sole traders or partnerships.[4] Under this proceeding, the debtor, acting under the supervision of a federal bankruptcy judge, may negotiate with its creditors a plan of reorganisation that allows for the restructuring of the debtor's liabilities.[5] Chapter 7 of the Bankruptcy Code, on the other hand, regulates liquidation proceedings.[6] Under this proceeding, the debtor's assets are typically liquidated by a trustee and the proceeds of the liquidation are distributed among the debtor's creditors, depending on the priority of their claims.[7] The debtor generally chooses whether the case is to be a Chapter 11 reorganisation or a Chapter 7 liquidation. A novel aspect of US insolvency law, when compared with English and French laws, is that upon filing a petition for reorganisation under Chapter 11, the debtor, sometimes identified as the debtor-in-possession (DIP), retains possession and control of its assets while undergoing a reorganisation.[8]

1 Title 11 of the United States Code (11 U.S.C.).
2 For a generic comparison of the features of these regimes, see Bliss & Kaufman (2011) 349.
3 BERGMAN *et al.* (2004) 13. For an analysis of the historical origins of the debtor-friendly approach of US bankruptcy law, see HANSEN & ESCHELBACH HANSEN (2007) 203.
4 11 U.S.C. §§ 1101 to 1174. Chapter 11 proceedings may be instituted by filing with the bankruptcy court either a voluntary petition filed by the debtor or an involuntary petition filed by creditors that meet certain requirements. See 11 U.S.C. §§ 301 & 303. Certain entities such as banks, savings and loans associations, insurance companies and a number of other statutorily defined financial entities are specifically excluded from becoming debtors under the Bankruptcy Code. See 11 U.S.C. § 109(b)(2). Such entities are subject to their own particularized insolvency regimes, including the FDIA in the case of federally chartered banks and savings and loan associations, and state laws in the case of insurance companies. Insolvent brokers and dealers are liquidated pursuant to the Securities Investor Protection Act (SIPA), although stockbrokers may also be liquidated under the Bankruptcy Code. See 11 U.S.C. §§ 741 *et seq.*
5 11 U.S.C. § 109.
6 11 U.S.C. §§ 701 to 784.
7 These priorities are set out in 11 U.S.C. § 507 and 726. See in this respect LUBBEN (2016) 581. Lubben describes in generic terms the basic order of payment as follows: '[…] secured creditors get paid first, unsecured creditors get paid next, and only then do shareholders get paid, if at all.' *Ibid.* The FDIA also provides a list of priority payments in 12 U.S.C. § 1821(d)(11)(A). See in this respect, BLISS & KAUFMAN (2006a) 15.
8 11 U.S.C. § 1101.

According to Skeel and Jackson, bankruptcy law's 'heart and soul' lie mainly in two principles, namely the automatic stay and the bankruptcy trustee's power to avoid preferential transfers.[9] The automatic stay is considered key to bankruptcy's collective proceeding since it prohibits creditors from taking enforcement action, thereby preventing a 'grab race'.[10] The second principle is the preference provision which, with various exceptions, empowers the debtor or, if one is appointed, the bankruptcy trustee to retrieve payments or other transfers made to a creditor within ninety days of bankruptcy.[11] A third equally important principle is the ability of debtors to 'assume or terminate' executory contracts,[12] which allows a debtor to cherry-pick which executory contracts to assume and which to terminate.

Two special resolution proceedings apply in relation to specified financial institutions. Under the first resolution regime, insured depository institutions are subject to the resolution proceedings of the Federal Deposit Insurance Act (FDIA). The FDIA empowers the Federal Deposit Insurance Corporation (FDIC) to act as receiver or conservator of the insured institution.[13] As receiver, the FDIC has the power to liquidate and wind up the affairs of an insured institution, while as conservator, the FDIC has the power to continue operating the insolvent insured institution. The goal of this regime is to resolve the financial distress of a failed bank in the manner that is least costly to the FDIC's deposit insurance fund,[14] unless the resolution is deemed necessary for systemic reasons.[15] The FDIC has several options as receiver for resolving institution failures, such as the transfer of all or some of the institution's assets and liabilities to a bridge institution owned and operated by the FDIC which would then enable the resolution of the closed institution.[16] The second resolution regime was introduced by Title II of the Dodd-Frank Act. This regime established the Orderly Liquidation Authority (OLA) which authorises the Secretary of the Treasury to appoint the FDIC as receiver of certain systemically significant

9 11 U.S.C. §§ 362(a) & 547, respectively. See SKEEL & JACKSON (2011) 158.

10 See also 11 U.S.C. § 365(e) which nullifies *ipso facto* contractual clauses such as clauses specifying that a bankruptcy filing will result in an automatic default and a termination payment.

11 11 U.S.C. § 547(b)(4).

12 11 U.S.C. § 365(a). Executory contracts under US law are those contracts which remain materially uncompleted by both parties, and thus have elements of both assets and liabilities. For a discussion of the types of contract under US law, see SKEEL & JACKSON (2012) 169.

13 See 12 U.S.C. § 1811 *et seq*. The FDIC is a US government corporation providing deposit insurance to depositors in US banks. See the FDIC website at <https://www.fdic.gov/>. To note that if an insured institution is a national banking association, it is also subject to certain provisions of the National Bank Act (12 U.S.C. 38).

14 12 U.S.C. § 1823(c)(4)(A)(ii).

15 12 U.S.C. § 1823(c)(4)(G).

16 12 U.S.C. §§ 1821(c)(13)(G)(II) & (n)(1)(B)(i)(ii). See in this respect BLISS & KAUFMAN (2006a) 9.

financial companies that are not federally-insured depositories.[17] The OLA regime applies to US bank holding companies, any companies mostly engaged in financial activities and any subsidiaries of such companies that are mostly engaged in financial activities (referred to as a 'covered financial company').[18] The purpose of the OLA regime is 'to provide the necessary authority to liquidate failing companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.'[19] The FDIC must determine that any action taken under the OLA regime is necessary for purposes of the financial stability of the US, rather than for the purposes of preserving the covered financial company, and must ensure that unsecured creditors bear losses in accordance with the priority of claims provisions of the OLA regime.[20]

The US 'Safe Harbours'

The regulation and recognition of close-out netting under US law is regulated by various laws, namely the Bankruptcy Code, FDIA, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and Dodd-Frank. Although these laws broadly regulate close-out netting provisions of financial contracts entered into between financial institutions, the exact scope of application varies from one law to another. The safe harbours are based on a three-pillar structure since they seek to protect the contractual rights of stipulated parties to particular financial contracts from the application of the Bankruptcy Code. Contractual rights typically include the ability to terminate and set-off or net payment and delivery obligations. The covered contracts include securities contracts, commodities contracts, repurchase agreements, forward contracts, swap agreements and master netting agreements in relation to these contracts. Protected parties generally comprise commodity brokers, forward contract merchants, stockbrokers, financial institutions, securities clearing agencies, repo participants and swap participants.[21]

17 12 U.S.C. §§ 5381-5394.
18 12 U.S.C. § 1841(a).
19 12 U.S.C. § 5384.
20 12 U.S.C. § 5386. In addition to these regulatory laws, the US prudential regulators have adopted regulations requiring systemically important financial institutions and certain subsidiaries to include contractual provisions in their financial contracts to ensure that counterparties opt in to the temporary suspension of termination rights of FDIA and OLA and to prevent counterparties from exercising default rights related to the entry into resolution of an affiliate of the financial institution. The regulations provide a safe harbor for contracts amended pursuant to the ISDA 2015 Universal Resolution Stay Protocol or similar protocol. See 12 C.F.R. §§ 252.83-84; 12 C.F.R. §§ 382.3-4; 12 C.F.R. §§ 47.4-5.
21 See 11 U.S.C. §§ 362(b)(6), 555, 556, 559, 560 & 561.

Schwarcz and Sharon list three ways in which the safe harbours protect contractual rights.[22] Firstly, protected counterparties are permitted to exercise their contractual enforcement remedies against a debtor or its property, including through closing out, netting and setting off amounts owed reciprocally, and liquidating collateral in their possession, notwithstanding the automatic stay on individual creditor action.[23] Secondly, the safe harbours exempt protected counterparties from the exercise of trustee avoiding powers in relation to preference rules and constructively fraudulent transfers regarding any payment and collateral received prior to the bankruptcy unless the transferee had actual intent to hinder, delay or defraud the debtor, its creditors or any receiver or conservator of the debtor.[24] Thirdly, bankruptcy law allows protected counterparties to enforce *ipso facto* termination clauses, and to net all existing contracts with the debtor with the consequence that the latter may not exercise any assumption or rejection powers which would have entitled it to terminate unfavourable contracts and demand execution of favourable ones.

A distinction is made by Bliss and Kaufman between executory and non-executory contracts and the treatment of close-out netting under each type of contract. Executory contracts are stated to consist of 'promises to transact in the future (but where no transaction has yet occurred)' whilst non-executory contracts arise 'where a payment by one party has already occurred.'[25] They state that whilst non-executory contracts may be accelerated in insolvency if they contain clauses that permit the creditor to accelerate future payments upon the occurrence of a stipulated event of default, executory contracts are simply terminated, thereby creating a claim for compensation, which is typically the cost of replacing the contract on identical terms with another solvent counterparty.[26] This distinction will be borne in mind when considering the constitutive elements of insolvency close-out netting under US law.

6.2 Constitutive Elements of Insolvency Close-out Netting

The relevant Bankruptcy Code provisions on the US safe harbours are found in sections 555 relating to securities contracts, 556 relating to commodities contracts and forward contracts, 559 relating to repurchase agreements and 560 relating to swap agreements. Sections 555 and 556 were both originally promulgated in 1982 and protect the contractual rights to liquidate, termi-

22 SCHWARCZ & SHARON (2014) 1718. In this respect, see also MOONEY (2014) 250; ADAMS (2014) 99. For an overview of the historical development of derivatives safe harbours under US law, see FAUBUS (2012) 821.

23 11 U.S.C. §§ 362(b)(6), (7), (17) & (27); 553(b)(1); 555-556, & 559-562.

24 11 U.S.C. §§ 546(e) - (g) & (j), & 548(d)(2).

25 BLISS & KAUFMAN (2006) 58.

26 *Ibid.*

nate and accelerate protected contracts. Section 559 was promulgated in 1984 and refers in addition to set-off rights. It was only in 1990 that the first mention and specific protection of netting was made in relation to swap agreements under section 560, in addition to the protection of the other rights. Netting rights are also specifically protected in Section 561, added in 2005, which provides for cross-product netting across the range of protected contracts so that close-out and netting are possible across all protected contracts if exercised under a master netting agreement.[27]

It is proposed to focus the analysis of the constitutive elements of close-out netting on those provisions of US law which specifically refer to the exercise of the contractual rights of close-out and netting. First, a commentary is made of two definitions which may shed light on the notion of close-out netting, namely the definitions of 'master netting agreement' in section 101(38A) of the Code and of 'netting contract' in section 402(14) of FDICIA. This is followed by a consideration of what are arguably the two main provisions on close-out netting under US law, namely: (i) section 560 of the Bankruptcy Code which, together with section 561 dealing with contractual rights under master netting agreements, is the only safe harbour provision that refers specifically to the netting of payment amounts or termination values; and (ii) section 403 of FDICIA which protects the enforceability of close-out netting agreements 'in accordance with their terms'.

Section 101(38A) of the Bankruptcy Code provides a definition of 'master netting agreement', which is the term used in section 561 of the same Code to protect cross-product netting in relation to the financial contracts covered by the US safe harbours. From a conceptual point of view, the following points resulting from this definition are indicative of the constitutive elements of close-out netting:

(a) A master netting agreement is stated to provide for the exercise of rights, including rights of netting, set-off, liquidation, termination, acceleration or close-out. This list reflects the list of contractual rights protected in the context of a master netting agreement in terms of section 561 and gives the impression that close-out and netting are considered as two separate rights forming part of a longer list of other contractual rights covered by this definition. This understanding is also in conformity with the fact that originally only the termination, acceleration and liquidation were protected under the initial safe harbours, with netting and offset being added as additional protected rights in section 560 of the Bankruptcy Code.[28] This is also made evident by the apparent lack of order in the listing of rights so that the reference to netting, contrary to the order

27 MORRISON & RIEGEL (2015) 649.

28 The idea of close-out and netting being separate rights rather than forming a single close-out netting mechanism is confirmed by Bliss and Kaufman when they state that '[c]lose-out and netting consist of two separate but related rights, often combined into a single contract'. See BLISS & KAUFMAN (2006) 58.

of events, precedes that of termination, liquidation, acceleration and close-out. Set-off is also considered as a right to be protected in a master netting agreement, which already indicates the close affinity with the close-out netting concept since a master netting agreement, of its own nature, refers to the multiple netting of payment obligations. This definition includes all possible aspects of terminating a contract, including by both outright termination (*i.e.* for an executory contract) and acceleration (*i.e.* for a non-executory contract). It is not clear if the term 'liquidation' adds anything in substance to the list of contractual rights contained in the definition. In theory, liquidation may be assimilated with termination or acceleration, or it may otherwise refer to the whole process of terminating or accelerating, calculating a close-out or set-off amount and proceeding to the actual set-off or netting so that liquidation is the end-result of this whole process. In this latter case, liquidation would also incorporate the various steps that constitute close-out netting as a single mechanism.

(b) Being a definition of a master netting agreement, its scope is limited to the netting of obligations arising out of the financial contracts covered by the safe harbours and listed in section 561(a) of the Bankruptcy Code. The scope is extended to any security or credit enhancement arrangement supporting the contracts. As a result, in establishing the close-out amount, the counterparties may also take into account in the calculation methodology any collateral arrangement entered into.[29] This indicates that the exercise of contractual rights relating to close-out and netting is protected irrespective of whether the close-out netting provision forms part of a financial collateral arrangement or not, as long as the financial contract falls within the list of protected agreements.

The second definition is that of 'netting contract' under section 402(14)(A)(i) of FDICIA. The definition applies in relation to sections 403 on bilateral netting and 404 on clearing organisation netting. Although it may not be considered as an exhaustive definition insofar as concerns the elements of close-out netting, this is a particularly interesting definition since it is related to the 'blanket' recognition of close-out netting provisions under section 403 of FDICIA which is analysed below. The following elements may be identified from this definition:

(a) The netting contract is envisaged to be between '2 or more financial institutions, clearing organisations or members.' The words '2 or more' financial institutions refers to the fact that this definition applies in relation to both bilateral netting contracts where netting is bilateral as well as to clearing organisation netting relating to a multi-party clearing or

29 See in this respect, BERGMAN *et al.* (2004) 20; JANGER *et al.* (2014) 3.

payment system.[30] The issue of multilateral netting and the need to have mutuality for close-out netting to be effective will be analysed later in this chapter.

(b) The netting envisaged under this definition is the netting of 'present or future payment obligations or payment entitlements.' This captures the netting of contractual rights emanating from both executory contacts resulting in the termination of present obligations as well as non-executory contracts leading to the acceleration of future obligations. This definition seems to be restricted to the netting of payment obligations and does not mention the netting of delivery obligations nor the taking into account of credit enhancement arrangements. However, this does not necessarily mean that the latter two elements have been excluded from this definition since following the calculation of the monetary values of delivery and collateral obligations, this will in any case result in a payment obligation or a payment entitlement. Hence, a payment obligation may, in the end, comprise also delivery and collateral obligations.[31]

(c) A netting contract is also envisaged to include the 'liquidation or close-out of values relating to such obligations or entitlements.' This phrase appears to imply that liquidation and close-out are similar concepts which achieve the valuation of payment obligations. US law may thus give a more limited meaning to liquidation than envisaged in the first definition considered above so that it is more probably limited to 'liquidating' contractual obligations into monetary values than to incorporating other rights such as set-off or netting rights. Another aspect of this phrase is that US law recognises that the methodology of liquidation of values will be that established by a netting contract and hence to be determined by party autonomy.

Arguably, the most prominent safe harbour in relation to derivatives, and the only one specifically referring to close-out netting, is section 560 of the Bankruptcy Code dealing with the contractual right to liquidate, terminate or accelerate a swap agreement. Section 560 preserves the contractual right of a swap participant or financial participant, in view of the financial condition of the counterparty, to liquidate, terminate or accelerate one or more swap agreements and to offset or net out any termination or payment amounts under it. In conformity with the other safe harbours, a contractual right under section 560 is stated to include also a right contained in a rule or bylaw of certain industry associations or a right arising under common or merchant law or by reason of normal business practice, whether or not the

30 The bilateral nature of close-out netting was confirmed by the court *In re Lehman Brothers Inc*, 458 B.R.134, 142-3 (Bankr. S.D.N.Y. 2011) where the court held that netting could only happen on an entity-by-entity basis and rejected the argument that a corporate group could be treated as if it were a single firm.

31 See BLISS & KAUFMAN (2006) 60.

right is evidenced in writing. The following three elements on the regulation of close-out netting may be derived from the provision of section 560:

(a) The exercise of liquidation, termination or acceleration rights arising under a swap agreement is triggered by the occurrence of an event of the kind specified in section 365(e)(1) of the Code. These events relate to the insolvency or financial condition of the debtor, the commencement of a case under the Bankruptcy Code and the appointment of a trustee in a case under the Code or of a custodian before the commencement of a case.

(b) The exercise of contractual rights 'to offset or net out any termination values or payment amounts' arises in connection with the termination, liquidation or acceleration of one or more swap agreements. Three points may be noted in this respect. First, offset[32] and netting are recognised as two alternative modalities to determine a close-out amount. Second, this provision recognises that the termination values arise in connection with a swap agreement so that the modalities of calculation are also contractually set in the agreement and are determined by party autonomy. Third, the words 'arising out of or in connection with' indicate that the termination (or close-out) and netting, although separate rights, are related when arising out of a financial contract such as a swap agreement. In other words, the netting should be preceded by the termination of the transactions.

(c) Contractual rights appear to be fully respected in this provision since all references to the exercise of contractual rights and to valuation modalities are stated to arise from contractual arrangements. The fact that section 560 refers to the exercise of contractual rights deriving from rules or bylaws of industry associations does not affect the exercise of contractual rights because the reference only adds to the various possibilities for the origin of the contractual rights and does not detract from the possibility that rights arise also (and solely) from bilateral arrangements.

32 When used in this context, the term 'offset' is assumed to be equivalent to 'set-off'. This appears to be confirmed by Bliss and Kaufman who define offset similarly to set-off as 'the canceling of reciprocal obligations to arrive at a net amount owed or claimed'. See BLISS & KAUFMAN (2006a) 17. However, in an earlier paper, Bergman *et al.*, state that '[s]et-off, netting, and offset are conceptually equivalent, but their legal treatments are distinct.' According to these authors, whilst set-off refers to the netting of individual contracts where the payment amount is settled in due course with the settlement of other claims in the insolvency, the term offset applies to the individual netting and close out of qualified financial contracts in order to achieve a single close-out amount. See BERGMAN *et al.* (2004) 5. This is the approach adopted by the legislator in section 553 of the Bankruptcy Code which, although entitled 'Setoff', refers in section 553(a) to the 'right of a creditor to *offset* a mutual debt'. Therefore, offset is the more specific term to be used in relation to the set-off of protected financial contracts.

The scope of application of section 560 is considered quite extensive. It has been stated that the definition of a 'swap agreement' is so wide as to include effectively all derivative contracts.[33] The definition also includes a clause which extends the Code's protection to any transaction that is 'similar' to the one listed in the definition itself[34] and to any collateral and other credit enhancements. This definition is deemed to overlap with the other definitions of the Code.[35] Also in relation to swap agreements, any party may be protected, and not only financial parties. On account of this, Morrison and Riegel note that in relation to the definition of swap agreement, essentially 'all derivatives have become swap agreements, all parties to them and all transfers in relation to them benefit from the Code's protections' leading to comprehensive 'financial market protection' as opposed to the protection of particular parties and particular agreements as well as the elimination of the three-pillar construction on which the safe harbours were traditionally built.[36]

The US courts have limited the application of the section 560 safe harbour which protects rights triggered by *ipso facto* clauses. The court in *Lehman Bros. Special Financing, Inc. v. BNY Corporate Transaction Services Ltd. (In re Lehman Bros. Holdings Inc.)*[37] held that an *ipso facto* clause must be specifically set forth in the swap agreement to fall within the safe harbour and consequently a flip clause[38] for credit-linked notes in the transaction documents did not meet this test because subordination is not 'liquidation, termination, or acceleration' of the swap. According to the ISDA US law opinion, the interpretation of this decision is that the flip clause would not be considered to fall within the safe harbours even if it were incorporated in the swap agreement itself.[39]

Section 403 of FDICIA has a special standing under US law since it recognises the enforceability of the termination, liquidation, acceleration and netting of payment obligations between two financial institutions under a netting contract '[n]otwithstanding any other provision of State or Federal law', other than certain provisions of the FDIA, the OLA and other

33 MORRISON & RIEGEL (2015) 648.

34 According to Krimminger, the reference to similar agreements is intended to accommodate innovation in the markets so long as these innovations are similar to agreements already protected. See KRIMMINGER (2006) 14.

35 For instance, swap agreements clearly cover also forwards. In this case it may be argued that the more restrictive safe harbours of the Code do not restrict protection for counterparties under other provisions of the Code.

36 MORRISON & RIEGEL (2015) 648 & 652.

37 422 B.R. 407 (Bankr. S.D.N.Y. 2010). This judgment was confirmed *In Lehman Bros. Special Financing, Inc.v. Ballyrock (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2010).

38 The flip clause was intended to reverse the priority of payment obligations owed to swap counterparties on the one hand and noteholders on the other, following a specified event of default.

39 See ISDA US law opinion at p 17.

Federal statutes.[40] This provision, similar to the safe harbours, protects the exercise of various contractual rights, including termination and netting rights, notwithstanding the financial condition of the financial institution. Close-out and netting are again treated as separate but related rights. The interesting feature about this section 403, and the reason why it is being mentioned here, is that it recognises the protection of these rights 'in accordance with, and subject to the conditions of, the terms of any applicable netting contract.' The role given to party autonomy under this provision is reminiscent of the standard of 'in accordance with its terms' applied under the EU's Financial Collateral Directive.

According to the ISDA netting law opinion on US law, where a particular transaction is not specifically enumerated in the Code, it is expected that the court will find that the transaction deserves the same treatment as swap agreements under the Code, provided the transaction is concluded between financial institutions and the agreement is a netting contract in terms of section 402 of FDICIA.[41] The reasons for this statement is that the scope of application of section 403 of FDICIA is not restricted to any particular product with the only limitation being the nature of the parties, *i.e.* that they are financial institutions.[42] Thus, between them section 560 of the Code and section 403 of FDICIA virtually cover the whole spectrum of the financial market insofar as regards the protection of close-out netting provisions.

Perhaps the two most distinct features which have emerged from the above analysis is that rather than focusing on the protection of close-out netting as a single mechanism, US law protects more generally the exercise of contractual rights of which close-out and netting are deemed to be separate rights linked together in a financial contract. The second feature is that both set-off (or offset) and netting are considered as alternate methods for determining a single payment amount upon the close-out of a financial contract so that a close affinity may be attributed to these two concepts. This affinity is the subject of analysis in the next part of this chapter. As in the previous national law chapters, first an overview of the concept of insolvency set-off under US law is made and this is followed by a comparative analysis of the constitutive elements of both concepts. This analysis

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40 These exceptions regard, *inter alia*, the regulatory and conservatory powers of the FDIC. Bergman *et al.* state that since FDICIA does not expressly prohibit a party from terminating an agreement as is the case under FDIA, the advice has been given by ISDA that a financial institution is able to exercise its close-out netting rights notwithstanding the FDIC's appointment as conservator. The FDIC, however, declared officially that in this situation FDICIA only enforces a party's netting rights but not the right to terminate an agreement. See BERGMAN *et al.* (2004) 19.

41 See ISDA 2018 Mayer Brown (the ISDA US law opinion) 14.

42 This is defined to include broker dealers, depository institutions, futures commission merchants and other entities recognised by the Federal Reserve regulation. On 7 March 1994 the Federal Reserve expanded the definition of financial institution to include most significant participants in the financial markets. See Regulation EE, 12 C.F.R. § 231.

will focus on the law of ordinary set-off rights as opposed to the exercise of offset rights related to the safe harbours which is considered later in this chapter.

6.2.1 Insolvency Set-off under US Law

The ordinary right of set-off under state law is primarily a matter of state substantive (as opposed to procedural) law.[43] Set-off is generally a voluntary act which must be invoked by the deliberate action of the creditor, thus indicating intent to effect set-off.[44] The Bankruptcy Code therefore does not create set-off rights, but only preserves set-off rights that arise under applicable non-bankruptcy law. In this regard, the relevant provision of the Code is section 553(a) which upholds the right of a creditor to set off mutual debts arising prior to the commencement of the bankruptcy proceedings '[e]xcept as otherwise provided in this section and in sections 362 and 363 of this title […].' Indeed, to the extent that a right of set-off existing under applicable state law may interfere with a provision of the Bankruptcy Code, the latter is supreme and the state law will be pre-empted.[45]

The recognition of state set-off rights in bankruptcy is entrenched in US legislative history. According to Morton, this recognition was initially codified in the Bankruptcy Act of 1800 and was later incorporated in the Bankruptcy Acts of 1841[46] and 1867,[47] the comprehensive Act of 1898[48] and the Chandler Act of 1938.[49] A number of restrictions found their way in the text of the various Acts and were carried forward in successive Acts. Thus, section 20 of the 1867 Act prohibited the set-off of obligations when acquired by the debtor after the filing of a voluntary petition or, in an involuntary case, after the act of bankruptcy. Section 68 of the Act of 1898 did not allow set-off if the mutual debts or credits were not provable or were acquired after the bankruptcy petition or within the previous four months

43 For an overview of the introduction of set-off in US state law, see SEPINUCK (1988) 53.

44 The courts have generally delineated three steps which must be followed to perfect a set-off, namely that the creditor decides to exercise set-off, takes affirmative action to do so and records the set-off. See *Baker v. National City Bank of Cleveland,* 511 F.2d 1016 96th Cir. 1975). See also *Contra United States v. Norton,* 717 F.2d 767 (3d Cir. 1983) where the court held that set-off is accomplished when a creditor gives sufficient evidence of intent to make a set-off such as the retention of funds by the creditor. Exceptions may arise in states where set-off is automatic such as under Pennsylvania law where no accounting record or other overt act is required to accomplish set-off.

45 Set-off, which is considered as an equitable right of a creditor to deduct a debt it owes to the debtor from a claim it has against the debtor arising out of a separate transaction, is y contrasted with recoupment (a notion derived from common law) in which the opposing claims arise from the same transaction. See US ATTORNEY MANUAL Part 65.

46 Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, 1841-04-19.

47 Bankruptcy Act of 1867, 14 Stat. 517, 1867-03-02.

48 Bankruptcy Act of 1898, Pub.L. 55-541, 30 Stat. 544.

49 Bankruptcy Act of 1838.

intended for such use and with knowledge that the bankrupt was insolvent or had pursued an act of bankruptcy.[50]

Historically, US courts have considered that the availability of set-off runs counter to the fundamental policy underlying bankruptcy law, namely a fair and proportionate distribution to creditors. Prior to the Bankruptcy Reform Act of 1978, a trend towards restricting set-off rights was developing in the courts in particular in relation to a debtor undergoing a bankruptcy reorganisation.[51] Thus, the Supreme Court in *Lowden v. Northwestern National Bank*[52] noted that section 68 of the Act of 1898 was 'meant in its enactment to prescribe the rule of setoff upon a distribution of assets'[53] and advocated a case-by-case assessment whether to allow set-off in reorganisation cases in order to give the debtor or his trustee the possibility to propose a plan of reorganisation. This led to a series of judgments holding that the rehabilitative purpose of reorganisation would be frustrated if creditors were permitted to set off at an early stage of the proceeding. At the same time, set-off in liquidation cases was considered favourably even though this could lead to a distributional preference.[54] By the time of the promulgation of the 1978 Act, however, the trend in court judgments was that set-off was a fair and equitable process to satisfy creditor's claims. Its enforcement nowadays lies entirely within the discretion of the bankruptcy court and is generally enforced unless there exist 'compelling reasons' not to do so.[55]

Prior to analysing the restrictions on the exercise of set-off rights upon insolvency, consideration will be made of the basic constitutive requirements of set-off under US law resulting from common law and, where applicable, from the Bankruptcy Code provisions. This is followed by a review of the Code provisions regulating the relationship between set-off rights and the bankruptcy proceedings in relation to the automatic stay, restrictions on creditor preferences and provisions to avoid fraudulent transfers. The rationale for this analysis, as in the previous two chapters,

50 MORTON (1976) 375.

51 For a discussion of the approach taken by jurists and the courts prior to the 1978 Bankruptcy Code towards set-off in a reorganisation procedure as being contrary to the 'fair and equitable' doctrine, see MORTON (1976) 384.

52 298 U.S. 160 (1936).

53 *Ibid.* 164.

54 For instance, see *Kolkman v. Manufacturers' Trust Co.*, 27 F.2d 659 (2 Cir. 1928); *Feakes v. International Trust Co.*, 8 F.2d 668 (D. Mass. 1925).

55 *United States v Carey (In re Wade Cook Fin. Corp.)*, 375 b.R. 580, 588 (B.A.P. 9th Cir. 2007); *In re NWFX, Inc.*, 864 F.2d 593 (8th cir. 1989); *In re Buckenmaier*, 127 B.R. 233 (Bankr. 9th Cir. 1991). Generally, courts have disallowed otherwise valid set-off in two categories of cases: (i) where the creditor committed an inequitable, illegal or fraudulent act, or the set-off is against public policy (see for instance *In re Cascade Roads, Inc.*, 34 F.3d 756 (9th Cir. 1994) where IRS set-off was denied because Government's conduct was inequitable) and (ii) where the set-off would significantly harm or destroy the debtor's ability to reorganise (see for instance *In re Cloverleaf Farmers Co-op*, 114 B.R. 1010 (Bankr. D.S.D. 1990) where set-off was denied because it was inconsistent with the purpose of Chapter 12 and the rehabilitation of American farmers).

is to gauge the extent to which close-out netting may be considered as a contractual enhancement of the concept of insolvency set-off.

Basic Requirements

It has been stated that section 553(a) of the Bankruptcy Code sets the parameters for the application of set-off rights as recognised by state law in relation to an insolvent debtor. It provides that a creditor seeking to exercise set-off must hold a 'claim' against the debtor. A 'claim' is widely defined under section 101(5) of the Bankruptcy Code to refer generally to any right to payment. A creditor seeking to exercise set-off must owe a 'debt' to the debtor. A 'debt' is defined in section 101(2) of the Bankruptcy Code as a 'liability on a claim'. The scope of the claim and debt is unrestricted except that they should constitute valid and enforceable obligations. According to Sepinuck, it is difficult to unequivocally establish the common requirements of set-off under state laws and no court or legislator has systematically laid down the elements necessary for set-off rights to accrue. Even if these issues are considered in one or more court judgments, the same reasoning is not necessarily followed in later judgments. Notwithstanding this, Sepinuck states that some basic requirements of set-off seem to command widespread consensus.[56] These basic requirements are indicated below.

Set-off is only possible in respect of mature obligations. It is, however, also typically permitted when, at the time the bankruptcy petition is filed, the debt is owed with certainty but is not presently due, or when a definite liability has accrued but is not yet liquidated.[57] Sepinuck notes that it is not clear from case law if there is an exception in relation to contingent debts upon the occurrence of insolvency. Unlike matured debts, contingent debts do not necessarily become due in time and the occurrence of insolvency may by itself be insufficient to warrant the possibility to set off claims.[58]

Debts must be liquid for the set-off to occur. If a debt remains unliquidated, for instance in relation to a claim based on a tortious injury, the debtor normally may not unilaterally determine the actual debt owed by the creditor. If agreement cannot be reached between the parties on a settlement, resort must be had to the courts in order to liquidate the claim through an estimation process. Sepinuck concludes that as a result set-off is typically restricted to liquidated debts.[59]

An essential requirement of the right of set-off is mutuality of debts. Thus, mutual debts, although not necessarily similar in nature, must be 'in the same right and between the same parties, standing in the same capacity', although, depending on the applicable state law, may not need to

56 SEPINUCK (1988) 67.
57 *In re Young*, 144 B.R. 45, 46-47 (Bankr. N.D. Tex. 1992).
58 SEPINUCK (1988) 68.
59 *Ibid*. 69.

arise from the same contract.[60] Thus, affiliated companies generally cannot aggregate their claims for set-off purposes. Indeed, as will be seen below, it is the purpose of the mutuality requirement to prevent what are referred to as 'triangular set-offs', namely a set-off among three or more affiliated entities. A creditor that takes an assignment of a third party's claim against a debtor satisfies the mutuality requirement and is eligible for set-off so long as the assignment occurred more than ninety days before the debtor filed for bankruptcy.

Some courts had created an exception to the general rule prohibiting triangular set-offs that permit set-off when the parties have entered into an express contractual agreement governed by US law to allow set-off among affiliates.[61] A decision of the US Bankruptcy Court in the District of Delaware, *Re SemCrude*[62] (*SemCrude*), overturned this exception and held that in a Bankruptcy Code proceeding, debts may be set off only where they are mutual in a strict sense, *i.e.* due to and from the same persons in the same capacity. According to the court, 'non-mutual debts cannot be transformed into a 'mutual debt' under section 553 simply because a multi-party agreement allows for set-off of non-mutual debts between the parties to the agreement.' The court considered that, contrary to the situation where one party guarantees another party's debts, an agreement to allow a set-off among affiliates does not create indebtedness from one party to another but simply recognises the parties' pre-existing rights to set off obligations. The court therefore chose to disregard principles of 'mutuality by contract' potentially available under state law in the light of the clear wording of section 553 of the Bankruptcy Code.

Restrictions on Insolvency Set-off

A first important restriction imposed on the application of set-off upon bankruptcy relates to the automatic stay. Section 362(a)(7) of the Bankruptcy Code provides that the commencement of a case in bankruptcy operates as a stay of 'the setoff of any debt owing to the debtor that arose before the commencement of the case […] against any claim against the debtor.' Section 553 of the Bankruptcy Code protects the set-off of mutual debts that

60 Joshua Cohn, 'Chapter 35: United States of America', in JOHNSTON *et al.* (2018), para 35.03. In this sense, the pre-petition debtor should also be treated differently from the DIP or the debtor's estate for set-off purposes.

61 This exception applies if the parties all agree in a pre-petition contract that a set-off may be taken between three parties, in the sense that two of them (typically affiliates) will be considered as a single entity for the purposes of the contract. The agreement may be enforced in bankruptcy to the extent it is enforceable under applicable non-bankruptcy law. The court *In re Lehman Brothers Inc*, 458 B.R.134, 141-2 (Bankr. S.D.N.Y. 2011), however, noted that this triangular set-off has been allowed only under state law or the common law of equitable receivership, but not under the more restrictive provisions of the Bankruptcy Code.

62 *Re SemCrude*, 399 BR 388, 396 (Bankr D. Del. 2009).

arose before the commencement of the bankruptcy case. Court approval is required to implement a right of set-off after the commencement of bankruptcy proceedings and a post-petition debt cannot set off a pre-petition debt so that both debts must be post-petition for the court to give its approval for the set-off.[63] Cohn explains that the automatic stay does not extinguish the right of set-off but postpones it pending an orderly examination of the debtor's and creditor's rights. In this respect, section 506(a) of the Bankruptcy Code provides that an 'allowed' claim[64] of a creditor that may be set off under section 553 of the Bankruptcy Code is treated as if it were secured to the extent of the amount subject to set-off. The creditor may preserve its rights by freezing the funds of the debtor in its hands but delay consummating set-off, while filing a proof of claim indicating the sum is held 'subject to' set-off without requesting relief from the stay until the bankruptcy trustee or debtor supplies adequate protection or compensation in terms of section 363 of the Bankruptcy Code. If adequate protection cannot be provided, relief from the automatic stay should be granted under section 362(d)(1) of the Bankruptcy Code.[65]

The second restriction relates to the prohibition of creditor preferences. Section 553(a)(2) of the Bankruptcy Code prohibits a creditor from setting off a claim that was transferred to it by a third party either after the commencement of the case in bankruptcy or within ninety days prior to the filing of the petition and while the debtor was insolvent. Section 553(a)(3) of the Bankruptcy Code further provides that where the creditor incurs a debt to the debtor, debts may not be set off when incurred within ninety days of filing and while the debtor was insolvent if they were incurred for the purpose of obtaining a right of set-off against the debtor. In addition, section 553(b) of the Bankruptcy Code provides that where a pre-petition set-off made during the ninety-day period has the effect of improving the creditor's position it will be recoverable by the trustee to the extent that the creditor has improved its position.[66] As an end result, Cohn states that since these preference provisions capture transactions that occurred up to ninety days prior to the commencement of the case in bankruptcy, the parties necessarily face a period of at least ninety days of uncertainty.[67]

63 *Bank, N.A. v. Grant (In re Apex Int'l Mgmt. Servs., Inc.)*155 B.R. 591, 594-95 (Bankr. M.D. Fla. 1993). While the Bankruptcy Code specifically allows pre-petition set-off, it is silent regarding the setting off of post-petition claims. However, courts have generally allowed the parties to set off claims post-petition in the same manner as pre-petition. See for instance *In re Seal*, 192 B.R. 442, 457 (Bankr. W.D. Mich. 196); *In re Mohawk Indus.*, 82 B.R. 174 (Bankr. D. Mass. 1987).

64 Section 502 of the Bankruptcy Code establishes a broad standard for 'allowability' of claims.

65 Joshua Cohn, 'Chapter 35: United States of America', in JOHNSTON *et al.* (2018), para 35.15.

66 See CLARK (1981) 230. Clark states that the improvement in position rule under section 553(b) only applies to prepetition set-off. The reason behind this appears to be to discourage prepetition set-off and thus leave working capital by which the trustee or DIP can rehabilitate the debtor. *Ibid.*

67 Joshua Cohn, 'Chapter 35: United States of America', in JOHNSTON *et al.* (2018), para 35.20.

The third restriction relates to fraudulent transfers. Section 548 of the Bankruptcy Code allows a trustee to avoid any fraudulent transfers made within two years before the filing of the debtor's bankruptcy petition. In terms of this provision a fraudulent transfer is, in generic terms, any transfer of an interest of the debtor in property or any obligation incurred by the debtor made or incurred with actual intent to hinder, delay or defraud any entity to which the debtor is indebted at a time when the debtor was or could become insolvent. To the extent that an obligation of the debtor is a fraudulent transfer, it is likely that the trustee would avoid that obligation and thus it would not be available to be set off against any debts owed to the debtor.

6.2.2 Insolvency Close-out Netting and Insolvency Set-off Compared

A distinction needs to be made under US law between ordinary set-off rights and set-off (or offset) rights protected under the safe harbours. Ordinary set-off rights, as seen above, started to develop in the 1800s and are, in principle, subject to the automatic stay. Offset rights recognised under the safe harbours are protected in the same manner, and were developed at the same time, as netting rights.[68] For the purposes of this research, it is therefore proposed to compare the concept of close-out netting with the concept of ordinary set-off rights (as opposed to offset rights arising under the safe harbours) since the development of ordinary set-off rights is ingrained in US legislative history and allows for the assessment of the contractual enhancement of close-out netting. In doing so, it is first proposed to briefly indicate the differences in the scope of application of the two concepts before carrying out a more detailed comparison of their constitutive elements.[69]

Scope of Application

A first important distinction relates to the scope of application of the concepts of ordinary set-off and close-out netting. Ordinary set-off applies in respect of any type of obligations entered into between a creditor and a debtor, whether contractual or not so that tortious obligations may also be considered. The debt and the claim need not arise from the same transaction nor must they be of the same nature.[70] Alternatively, netting rights are protected under the safe harbours if (i) both parties are swap participants or financial participants to swap agreements in terms of section 560 of the

68 Bergman *et al.* confirm that the right of offset under financial contracts does not meet the ordinary set-off requirements under state law. See BERGMAN *et al.* (2004) 21.

69 Consistent with the approach taken in this chapter, the analysis will focus on the close-out netting safe harbour provided in section 560 of the Bankruptcy Code, with reference being also made to section 403 of FDICIA where deemed relevant.

70 See US ATTORNEY MANUAL Part 65.

Bankruptcy Code or (ii) they benefit from a master netting agreement in relation to protected agreements in terms of section 561 of the Bankruptcy Code or (iii) they are financial institutions to netting contracts as defined under section 402(14) of FDICIA. It has been noted in part 6.2 of this chapter that given the wide definitions of swap agreements, swap participants and financial participants under the Bankruptcy Code, Morrison and Riegel have commented that these definitions are considered wide enough to extend to all derivatives contracts and to any parties and not just swap and financial parties. Given that both netting and offset rights are protected under the safe harbours, ordinary set-off rights are therefore applicable in respect of all other contracts which are not swap agreements under section 560 of the Bankruptcy Code or other financial contracts protected under a master netting agreement in terms of section 561, if the requirements of section 553 of the Bankruptcy Code are fulfilled.

Basic Requirements

It is to be borne in mind that under US law the ordinary right of set-off is created by state law and only preserved by the Bankruptcy Code, so that for certain aspects of the comparative analysis of the basic requirements reliance will be placed on doctrine and common law as already cited above. It is further proposed to consider whether close-out in the form of termination and acceleration applies also to ordinary set-off as it applies to netting.

Mutuality is a basic requirement for set-off to apply meaning that the obligations are held by the same parties in the same capacity and both arise either pre-petition or post-petition. It has been seen in part 6.2.1 that the court in *SemCrude* denied the benefits of set-off under section 553 of the Bankruptcy Code in the case of triangular set-off arrangements for lack of mutuality. Following this decision, it was questioned whether a right of set-off under a swap agreement which is not allowable under section 553 for lack of mutulity is nonetheless protected if it fulfils the requirements of the safe harbours. According to Bienenstock, if the relevant contracts fall under any of the safe harbour provisions and if the triangular set-off agreement is intended to serve as credit enhancement, the creditor could invoke the safe harbour since the safe harbour provisions override any provision of the Bankruptcy Code, including section 553. Bienenstock notes that the term 'contractual right' is broadly defined under section 560 of the Bankruptcy Code to include a right 'whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice' that it would appear that the language of the safe harbour provisions lifts the mutuality requirement necessary for the exercise of ordinary set-off rights.[71]

71 BIENENSTOCK *et al.* (2009) 338.

This reasoning was, however, refuted by the court in *In re Lehman Brothers Holdings Inc.* (*Swedbank*)[72] and *In re Lehman Brother Inc.*[73] where it was noted that the safe harbour provisions do not modify the fundamental principles of section 553 requiring mutuality and, in the absence of an express mention of mutuality in sections 560 and 561 of the Bankruptcy Code, the court declined to read an exception into the safe harbour provisions. It held that whilst the safe harbours permitted the exercise of the contractual right of offset in connection with swap agreements notwithstanding the operation of any provision of the Bankruptcy Code to stay, avoid or otherwise limit that right, however that right must exist in the first place. In *Swedbank* the court added that the requirement for both obligations to be pre- or post-petition for mutuality to subsist should also apply under the safe harbours.[74] The need for mutuality to exist for close-out netting is confirmed in section 403 of FDICIA where the protection of close-out netting in bilateral netting is granted in arrangements 'between any 2 financial institutions'.

Other than for observance of the mutuality requirement, no other requirement restricts the exercise of contractual rights under the safe harbours so that these may be exercised even if the respective obligations are not mature or liquid as long as the modality for calculating 'termination values' and 'payment amounts' following the close-out is foreseen in the swap or other protected agreement.[75] The situation is not so liberal in relation to ordinary set-off rights even though the courts may intervene to facilitate the fulfilment of certain requirements. Thus, debts which are not liquid may in the end be rendered liquid through the intervention of the courts which perform an estimation process. Similarly, whilst it is possible to accelerate the maturity of debts to permit ordinary set-off of obligations that are certain or have accrued but are not yet liquidated, it has been stated that the courts generally prohibit the set-off of debts which are contingent on some event which has not yet occurred.

Although US courts may permit the acceleration of the maturity of obligations under set-off (except where the maturity depends on the occurrence of a contingency which has not yet materialised), this may not be equivalent to the right to close out exercisable under the safe harbours. Indeed, the question arises whether the exercise of ordinary set-off rights upon insolvency is also associated or is preceded by the close-out of a contract or the

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72 *In re Lehman Brothers Holdings Inc. et al.*, 433 B.R. 101, 109 (Bankr. S.D.N.Y. 2010). This case concerned the set-off of pre-petition funds with post-petition funds.

73 *In re Lehman Brothers Inc*, 458 B.R.134, 142-3 (Bankr. S.D.N.Y. 2011). This case concerned set-off under a triangular arrangement.

74 *In re Lehman Brothers Holdings Inc. et al.*, 433 B.R. 101, 112 (Bankr. S.D.N.Y. 2010).

75 In terms of the ISDA US law opinion, party autonomy extends to the selection of the currency in which the close-out netting amount may be denominated although for the purposes of US insolvency proceedings, any claims of the counterparty of the debtor or any judgment in favour of the counterparty that is denominated in a currency other than US dollars must be converted into US dollars. See the ISDA US law opinion at p 14.

termination or acceleration of obligations. It is doubtful whether the acceleration of the maturity of obligations of ordinary set-off rights is equivalent to the termination or acceleration of those obligations.[76] Under section 362(a)(7) of the Bankruptcy Code, the automatic stay is imposed on the set-off of any debt that 'arose before the commencement of the case under this title against any claim against the debtor.' Section 553(a) of the Bankruptcy Code only allows the exercise of ordinary set-off rights if both the creditor's and debtor's claim and debt arose before ninety days from the date of the filing of the petition. Thus, even if the maturity of debts subject to ordinary set-off may at times be accelerated by the court, it cannot be stated that the law foresees the possibility to close out contracts in order to permit the exercise of ordinary set-off rights. This conclusion is strengthened by the fact that whilst section 560 of the Bankruptcy Code protects *ipso facto* clauses and foresees the possibility to terminate a protected contract 'because of a condition of the kind specified in section 365(e)(1) of this title', no such possibility exists for the exercise of ordinary set-off rights.

The difference between the concepts of ordinary set-off and close-out netting is perhaps most apparent from two additional aspects. First, US law has created the notion of safe harbour set-off which, for all intents and purposes, is also preceded by close-out and benefits from the same safe harbour protections as netting. Under the safe harbours, set-off and netting are considered as two alternate modalities that may be used for the calculation of a close-out amount. In this sense, the safe harbour set-off does not seem to require observance of the basic requirements of ordinary set-off, other than mutuality, for its validity. Secondly, whilst the concept of ordinary set-off gradually became to be considered a fair and equitable process for the payment of debt, it shall be seen in the latter part of this chapter that close-out netting developed mostly out of concerns of systemic risk which the insolvency of a financial institution could bring on the market.[77] It does not appear from the various considerations and declarations made by Congress during the successive expansions of the safe harbours that these were based on considerations of equity or fairness. On the contrary, the safe harbours were enacted on the understanding that considerations of equity and fairness had to give way to considerations of protecting the market against systemic risk. All in all, given the different standards and considerations which nowadays surround the concept of close-out netting it may be fair to state that it goes beyond the notion of being a contractual enhancement of ordinary set-off and may be considered as a completely separate concept.

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76 It is also important to reiterate the point made in part 6.2.1 that claims and debts which may be subject to ordinary set-off do not necessarily arise by contract but may result from a tortious situation. In this case, the acceleration of the maturity of an obligation is not tantamount to the close-out of a contract.

77 It may be for this reason that the exercise of safe harbours set-off developed differently from ordinary set-off.

Insolvency Proceedings

Whilst the creditor of an ordinary set-off right is generally subject to the automatic stay and to the ninety-day suspect period, the safe harbours insulate the holders of protected contracts from most avoidance powers such as preferences and fraudulent transfers, other than fraudulent transfers with actual intent to hinder, delay or defraud creditors.[78] Indeed, in terms of section 560 of the Bankruptcy Code, the exercise of protected contractual rights 'shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.' For instance, a situation where the liquidation of protected contracts may be deemed a preference or constructively fraudulent transfer and hence voidable, is when it is entered into after the derivative trading has begun and it produces the effect of obliging the debtor to assume a debt without any corresponding benefit to it and while the debtor is insolvent.[79]

6.3 The Recognition of Close-out Netting Provisions Before and After the Adoption of a Bank Resolution Regime

The law on the safe harbours started to evolve with the adoption of the new Bankruptcy Code in 1978.[80] The protection of close-out netting provisions developed in a piecemeal fashion whereby the protection of certain contracts under the Bankruptcy Code resulted in the protection of the clauses and contractual rights typically found in these contracts. With each amendment, the protection of contractual rights was viewed as crucial to protect the viability of both the individual counterparties and of the relevant market. According to Krimminger, this underlying goal remained consistent throughout the gradual expansion of these protections from 1978 to the new Title IX of FDIA enacted by the Bankruptcy Reform Act of 2005.[81] It is proposed to first analyse the expansion of the safe harbours, including the rationale therefor, in order to assesses the extent of recognition given to close-out netting provisions. This is followed by an examination of the extent to which applicable resolution regimes have restricted the enforcement of close-out netting rights.

78 See 11 U.S.C. § 546(e) to (g).
79 BIENENSTOCK *et al.* (2009) 340.
80 Bankruptcy Reform Act of 1987, Pub.L. 95-598, 92 Stat. 2549.
81 KRIMMINGER (2006) 7.

Expansion of Bankruptcy Code Safe Harbours

The initial exemptions of 1978 included two provisions granting limited protection to commodity and forward contracts from the automatic stay for non-debtor forward merchants and brokers with respect to margin payments or deposits received from a debtor.[82] These safe harbours were intended to 'promote customer confidence in commodity markets' by protecting the commodity market stability.[83] These protections were extended in 1982[84] to the securities contracts and to the margin and settlement payments of brokers, clearing organisations and financial institutions.[85] These initial safe harbour expansions were narrow in scope. As amended in 1982, sections 555 and 556 only extended safe harbour protections to a select, narrowly-defined group of financial contracts and the right to liquidate a securities contract was granted only to a limited group of parties also narrowly defined to include stockbrokers and securities clearing agencies. In addition, the safe harbours only exempted from the automatic stay the contractual right to cause liquidation which was strictly limited to those rights 'set forth in a rule or bylaw of a national securities exchange, a national securities association, or a securities clearing association', so that the rights deriving exclusively from the securities contract itself were not protected.

Following this expansion, some court decisions raised doubts whether repo agreements were protected for closing out positions under the safe harbours.[86] This led to a further expansion of the safe harbours in 1984[87] to cover repurchase agreements and included the exemption of the set-off of repo obligations from the automatic stay and the protection of margin and settlement payments for repos from avoidance. The amendment also broadened the range of parties entitled to the exemptions beyond specific and defined parties but imposed a ninety-day limit for the allowability of obligations. A repurchase agreement, however, was narrowly defined to agreements for the transfer of certificates of deposit, bankers' acceptances or

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82 See Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549. In this respect, section 362(b)(6) of the Code provided an exception to the automatic stay for the set-off of claims under commodity and forward contracts. Section 546 (originally section 764(c)) of the Code prevented a debtor or trustee from avoiding and recovering settlement and margin payments on commodity and forward contracts made by the debtor before the bankruptcy filing.

83 S. Rep. No. 989, 95th Cong., 2d Sess. 8, reprinted in 1978 U.S.C.C.A.N. 5785, 5794.

84 See Act of July 27, 1982, Pub. L. No. 97-222, 9 Stat. 235.

85 This extended protection was added by 11 U.S.C. § 546(f).

86 See in particular *Lombard-Wall, Inc. v. Columbus Bank & Trust Co.* No. 82B 11556 (Bankr. S.D.N.Y. 1982) where the court held that the automatic stay barred the holder of securities under a repo from closing out its positions without approval by the court.

87 This expansion was enacted via sections 362(b)(7), 546(f) and 559 of the Bankruptcy Code through the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-252, 98 Stat. 333.

US government securities.[88] In 1984 Congress added 'financial institution' to the list of protected parties in sections 546(e), formerly 546(d), and 555, which was widely defined.[89] The term 'contractual right' was more broadly defined to include, besides written rules of relevant market associations, any right 'whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.' In addition, the authorisation to liquidate a repurchase agreement notwithstanding the automatic stay included permission to foreclose on the underlying collateral.

In 1990 Congress extended the protection from the automatic stay and avoidance powers to swap agreements through the introduction of section 560.[90] The 1990 amendment added to the scope of the existing safe harbours an important aspect in that it explicitly protected the exercise of netting rights. The reason for this addition was that since swaps are traded between parties according to conventions established in master agreements, the industry feared that without an explicit exemption in the Bankruptcy Code the practice of netting would be prevented by the automatic stay.[91] In addition, unlike previous amendments which gradually opened up the safe harbours to limited types of derivatives agreements, section 560 extended safe harbour protections to all swap participants, a term broadly defined to include any 'entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor.' As noted in part 6.2, the term 'swap agreements' was also widely defined to include a long list of derivatives transactions as well as 'similar' agreements and any collateral or credit enhancements[92] and since none of the transactions mentioned in the definition were themselves defined, a judge was presumably expected to rely on market definitions.[93] The source for the contractual rights was also expanded to cover any liquidation or termination of a forward contract, even those arising from 'any right […] under common law, under law merchant, or by reason of normal business practice, whether or not evidenced in writing.'[94] This indicates that the enforcement of close-out netting may go beyond the confines of contractual provisions and extend to customary law and *lex mercatoria*. Admittedly, this may be just a relic of the wording used in the older safe harbours[95] so that today close-out netting in relation to swaps is more likely to be exercised under contractual provisions rather than customary law. Indeed, unless the modalities for calculating

88 See Act of July 10, 1984, Pub. L. 98-353 (HR 5174), amending 11 U.S.C. § 101(36).
89 11 U.S.C. § 101(19) (1984).
90 See Act of June 25, 1990, Pub. L. No. 101-311, 104 Stat. 267.
91 SCHWARCZ & SHARON (2014) 1730.
92 11 U.S.C. § 101(49)(A).
93 See MORRISON & RIEGEL (2015) 646.
94 Act of June 25, 1990, Pub. L. No 101-311 tit. II, sec. 205, § 556, 104 Stat. at 267.
95 Namely, sections 555, 556 & 559 of the Bankruptcy Code.

close-out amounts are set by contract, it is no longer feasible to exercise close-out netting rights of complex and innovative derivatives products on the basis of unwritten customary practices as permitted in section 560 of the Code.

Another major statutory change occurred in 1991 with the adoption of FDICIA which confirmed the enforceability of the netting of payment obligations among financial institutions under a netting contract '[n]otwithstanding any other provision of State or Federal law'[96] and notwithstanding any 'stay, injunction, avoidance, moratorium or similar proceeding or order, whether issued or granted by a court, administrative agency, or otherwise.'[97] FDICIA is particularly significant because, unlike the Bankruptcy Code, it is not linked to specific types of contracts. As a result it is deemed to provide broader netting rights and according to Krimminger may have solved any doubts in relation to those safe harbours which did not explicitly exempt netting provisions from the effects of the Bankruptcy Code.[98] This is confirmed by the ISDA US law opinion where it is deemed that '[…] because Congress intended to reduce systemic risk in enacting Sections 401-407 of FDICIA, it appears that the correct view would be to construe broadly the application of FDICIA so as to include Transactions that may not fall within the definition of "swap agreement", provided both parties are financial institutions.[99] However, this extended protection is provided only to financial institutions that meet certain thresholds qualifying them as major market dealers.[100]

In 2005 the Bankruptcy Abuse Prevention and Consumer Protection Act[101] (BAPCPA) was enacted to provide a common set of rules covering all participants in the financial markets. According to Schwarcz and Sharon, BAPCPA 'gave free rein to derivatives counterparties to completely circumscribe the Bankruptcy Code's automatic stay and preference rules.'[102] It did so by first expanding the Code's definitions of 'securities contract', 'commodities contract', 'forward contract', 'repurchase agreement' and 'swap agreement'[103] to provide safeguards for broad segments of the derivatives market. Secondly, BAPCPA expanded the safe harbours by the

96 Exceptions to this statement include 12 U.S.C. § 1821(e) on powers of conservators and receivers under FDIA with respect to contracts entered into before appointment of the conservator or receiver; 12 U.S.C. § 5390(c) which is the corresponding provision of the Dodd-Frank Act; and any order authorised under Section 5(b)(2) of the Securities Investor Protection Act of 1970.

97 See, generally, 12 U.S.C. § 4401-4407.

98 KRIMMINGER (2006) 8.

99 See ISDA US law opinion at p 33.

100 See WALDMAN (1994) 1076. The definition of financial institutions for the purposes of section 403 of FDICIA was referred to in part 6.2 and is similar to the definition of financial participant for the purposes of BAPCPA, considered below.

101 Pub.L. No. 109-008 (2005).

102 SCHWARCZ & SHARON (2014) 1733.

103 See BAPCPA §§ 907, 101(25), 101(53B),741(7) & 761(4).

addition of a general definition of financial participant,[104] thus bringing within the scope of the safe harbours large institutions not covered by the other definitions. Thirdly, the terms 'master netting agreement' and 'master netting agreement participant' were added to the list of protected contracts and protected parties, and provision was made for the exercise of cross-product netting, set-off, liquidation, termination, acceleration or close-out rights with respect to securities contracts, commodity contracts, forward contracts, repos and swap agreements.[105]

Further expansions occurred in 2006 through the enactment of the Financial Netting Improvements Act of 2006.[106] The section 362 Bankruptcy Code exemptions from the automatic stay were substantially reworded to bring them in line with similar provisions in FDIA and the Federal Credit Union Act. Sections 546(e) and (j) were expanded in scope to protect all types of transfers made by the protected parties from the trustee's avoidance powers.

According to Edwards and Morrison, the end result of this gradual expansion is that counterparties to a derivatives securities contract may now terminate, modify or liquidate assets of the debtor unhindered by the bankruptcy filing of a debtor if they hold other assets of the debtor they can use to reduce their exposures through an offset or netting.[107] It would thus appear that there is nothing to fetter party autonomy in the exercise of close-out netting rights under the US safe harbours. This has given rise to the question posed by Peck, Mokal and Janger whether the bankruptcy safe harbours have evolved to the point that:

> 'they have become so overly broad and all-encompassing that they frustrate some of the fundamental rehabilitative and distributive goals of bankruptcy by embracing transactions with little or no systemic significance that do not deserve to be immunized from collective bankruptcy treatment.'[108]

Although later developments did not go in the direction of the question raised by these authors, the free rein given to party autonomy started to be restricted in relation to systemically important institutions by the establishment of special resolution regimes, underlying a new understanding by Congress that the protection of systemic risk brought new considerations of

104 A financial participant includes any entity that, at the time it enters a securities contract, commodity contract, swap agreement, repurchase agreement or forward contract, or at the time of filing of its bankruptcy petition, holds a total of $1 billion in notional or actual principal amount of derivative transactions or gross mark-to-market positions of not less than $100,000,000 aggregated across parties, in one or more agreements with the debtor on any day during the prior fifteen-month period.

105 BAPCPA §§ 907, 101(38A).

106 Act of December 12, 2006, Pub. L. No 109-390, 120 Stat. at 2692.

107 EDWARDS & MORRISON (2005) 3.

108 PECK *et al.* (2011) 17.

financial sector stability which resulted in the controlled exercise of close-out netting rights.

Bank and Other Resolution Regimes

It will be recalled that the two US resolution regimes, the FDIA and the OLA regimes, operate in different ways. Whilst all insured credit institutions falling within the scope of FDIA are regulated by FDIA to the exclusion of the Bankruptcy Code,[109] the OLA regime only applies to non-bank financial institutions which are determined under the OLA regime to be systemically important. Once a determination has been made under the OLA regime, these institutions are no longer governed by the Bankruptcy Code.[110] Both regimes protect the right of parties to qualified financial contracts (QFCs) to close out, offset and net, and exercise security or credit enhancement rights,[111] but both also impose certain restrictions on these rights to protect the resolution of institutions which they govern. QFCs are defined to include securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements.[112]

Thus, FDIA reinforces the statutory ban on *ipso facto* clauses triggered solely on grounds of the financial condition of the institution and the appointment of the FDIC as receiver and temporarily stays the exercise of close-out netting rights until the earlier of 5:00 p.m. (eastern time) on the business day following the date of the appointment of the receiver or of a notice of transfer of the contracts to another bank or to an FDIC-owned bridge bank.[113] It was debatable in relation to the safe harbours whether counterparties could terminate agreements and destroy value to a receiver by the use of walkaway clauses which entitle a solvent party to suspend or extinguish a net payment right or avoid payment solely because of the status of the insolvent counterparty as a defaulting party under the contract. The FDIA regime brought an end to this uncertainty by prohibiting outright this type of clauses.[114]

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109 See in this regard, CAMPBELL & MOFFATT (2015) 70. It is also to be noted that the US bank resolution regime is much older than the English and French bank resolution regimes.

110 This is confirmed in LUBBEN (2017) 69.

111 12 U.S.C. §§ 1821(e)(8)(A) & 5390(c)(8)(A).

112 12 U.S.C. §§ 1821(e)(8)(D)(i) to (vi) & 5390(c)(8)(D)(i) to (vi). These definitions are broader than those of the Bankruptcy Code since they define certain protected contracts more inclusively and do not include the Code's limitations of protection only to specified counterparties. The term QFC also extends to any 'similar agreement' that the FDIC determines by regulation, resolution or order to be a qualified financial contract.

113 In conservatorship, the general rule against the enforceability of *ipso facto* clauses applies. Counterparties may not terminate, close out or net QFCs solely on account of the insolvency, financial condition or appointment of the conservator. This in effect continues all relationships under their existing contractual provisions. See 12 U.S.C. § 1821(e)(10)(B)(i) & (ii).

114 This applies in both receivership and conservatorship. See 12 U.S.C. § 1821(e)(8)(G)(i).

Some safeguards have also been put in place. The receiver or conservator may not avoid any transfer of money or other property in connection with the QFC, unless the transferee had actual intent to hinder, delay or defraud the institution, the creditors of the institution or any receiver or conservator of the institution.[115] If the receiver is to transfer any QFCs to a third party, the receiver must transfer all QFCs with the same counterparty, including its affiliates, to one depository institution transferee and notify the QFC counterparty of the transfer by a specific deadline on the business day after appointment of the receiver.[116] These safeguards ensure to some extent that the close-out netting mechanism, although temporarily delayed in implementation, remains intact.

The OLA regime continues to offer safe harbours for QFCs, similar to those offered by FDIA. These safe harbours are potentially broader than those of the Bankruptcy Code because they apply to all QFC counterparties and not only to the counterparties listed for protection under the Code. Similar to FDIA, it further provides that neither payments made nor collateral transferred by a covered financial company in connection with a QFC may be avoided by the FDIC except where the transferee intended to 'hinder, delay, or defraud' the creditors or the receiver of the covered financial company.[117] In addition, in a transfer of assets the FDIC may not cherry-pick among QFCs and if any QFC with a given counterparty is transferred, all QFCs with that counterparty or its affiliates must be transferred to the same party, together with all claims, security and credit enhancements.[118] However, *ipso facto* clauses related to the exercise of termination, netting and set-off rights solely on account of the appointment of the FDIC as receiver or the financial conditions of the financial company in receivership are stayed from the moment the receivership commences until 5:00 p.m. on the next business day or until the protected party has received notice that its QFC has been transferred to another financial institution, including a bridge financial company.[119] OLA also nullifies walkaway clauses which are solely based on the financial institution's insolvency or the appointment of the FDIC as receiver.[120] In terms of the ISDA US law opinion, these provisions considered together 'should ensure that credit exposures to an insolvent covered financial company can be calculated on a net basis pursuant to the terms of an ISDA Master Agreement',[121] thus confirming the statement made earlier in relation to FDIA that the close-out netting mechanism remains functional, although its operation is temporarily delayed.

115 12 U.S.C. § 1821(e)(8)(C)(i) & (ii).
116 12 U.S.C. § 1821(e)(9) & (10).
117 12 U.S.C. § 5390(c)(8)(C).
118 12 U.S.C. § 5390(c)(9)(A).
119 12 U.S.C. § 5390 (c)(10)(B) & (D).
120 12 U.S.C. § 5390 (c)(8)(F)(i) & (iii).
121 See ISDA US law opinion at p 30.

Adams notes that whilst the Dodd-Frank Act provides numerous tools for systemic risk dispersion, the Bankruptcy Code safe harbours may interfere with the effectiveness of the ability for the FDIC to intervene after a non-bank financial institution determined to be systemically important has filed for bankruptcy.[122] According to Adams, once a bankruptcy has triggered the exercise of liquidation rights within the derivative safe harbours, OLA intervention is without effect. This is due to the fact that whilst OLA contains a stay on *ipso facto* clauses, there is nothing to empower OLA to assume a contract that had already been terminated and closed out. Congress' concern under OLA is about systemic risk and not about the resolution of the debtor. Thus, OLA must quickly decide whether there is systemic risk before the debtor takes action to file for bankruptcy. According to Adams, this places the decision when an institution is in financial distress in the hands of the person least able to evaluate it, the distant policy-maker, and may serve to hasten the decision-making in cases where insufficient information is available, thereby 'creating the potential for less resolute action and unhelpful political reactions.'[123] It also evidences that the exercise of party autonomy in relation to the safe harbours may trump the more restrictive OLA regime if the bankruptcy regime is put in motion before a determination of systemic importance has been made under the OLA regime.

6.4 Rationale of US Insolvency Law

Referring to the safe harbours, Faubus notes that no other financial instrument 'receives such preferential treatment under the Bankruptcy Code.' He states that whilst the purpose for this favourable treatment according to legislative history is to regulate systemic risk, the understanding how Congress intends the safe harbours to reduce systemic risk requires an understanding of the basic mechanics of bankruptcy proceedings.[124] It is the scope of this part of Chapter 6 to analyse the interaction of the recognition granted to close-out netting provisions under the safe harbours with the rationale and general principles of US insolvency law. The ulterior motive behind this analysis is to understand the justification for the policy goals that led to the recognition of close-out netting provisions in derogation of these general insolvency principles.

Given and Philipps note that from its inception 'as a colonial alternative to the English debtors' prisons' US bankruptcy law has been founded on two pillars, namely the discharge for the debtor and the equality of treatment for the debtor's creditors. According to these authors, discharge

122 12 U.S.C. § 5388.
123 ADAMS (2014) 109.
124 FAUBUS (2010) 823.

encourages risk-taking by offering the deserving debtor the possibility of a fresh start, whilst equality of treatment of creditors promotes a fair and orderly liquidation of the debtor's assets.[125] In this respect, Warren states that Congress realised that if legal rules make it difficult for a troubled firm to survive or if they increase the costs of operation, value will necessarily decline sharply when a firm is in trouble. Conversely, if the rules give the business opportunities to reorganise its debt and offer protection from collecting creditors, the rules will prop up the value of the troubled business.[126] It would thus seem that two important aspects that have shaped the rationale of the US insolvency regime are the encouragement of risk-taking and giving the failed debtor a second chance.

Under the Bankruptcy Code, if a bankruptcy petition is filed voluntarily or involuntarily for a debtor, the Bankruptcy Code broadly provides a system of rules designed to achieve rehabilitation or liquidation and payment of some portion of the debts due to creditors. Chapter 11 establishes a reorganisation procedure whose policy objective, according to Finch, is strongly oriented to the avoidance of the social costs of liquidation and the rehabilitation of the corporate operation. There is no requirement for the debtor to be insolvent or near insolvent[127] in order to trigger the Chapter 11 protection which may indicate that the process is an instrument for debtor relief, not a remedy for creditors.[128] McCormack, however, considers that the approach to bankruptcy reorganisation has changed and the objective of maximising creditor recoveries has come to assume a greater prominence so that asset sales have begun to predominate rather than reorganisations in the traditional sense. Thus, McCormack states that the 'pre-packaged' bankruptcy, which he considers to have gained in importance, mixes elements from private restructuring whereby agreement is reached with creditors on the restructuring process and the traditional Chapter 11 which is used to implement the agreement.[129]

In a regime which has pro-debtor tendencies, the obvious question which arises is how the safe harbours, with their evident pro-creditor approach, fit in this scenario? The safe harbours have, as a matter of policy, been justified by the effort of Congress to counteract systemic risk by excepting derivatives and other financial contracts from several key bankruptcy rules.[130] Ayotte and Skeel note that although the safe harbours could reduce systemic risk in some cases, they may 'throw oil on the fire' in others.

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125 GIVEN & PHILIPPS (1982) 735.

126 WARREN (1993) 344.

127 The Bankruptcy Code sets a balance sheet test for determining insolvency in the case of entities and partnerships. See 11 U.S.C. § 101(32)(A) & (B).

128 FINCH & MILMAN (2017) 195.

129 McCORMACK (2009) 119 &128.

130 In terms of section 560 of the Bankruptcy Code, swap agreements 'shall not be stayed, avoided, or otherwise limited by operation of any provision of this title [11] or by order of a court or administrative agency in any proceedings under this title.'

Thus, the counterparties' ability to execute their contracts when a debtor files for bankruptcy can create a run on the debtor's assets as other counterparties also proceed to terminate their contracts and to seize any collateral securing the contracts. This was the situation with Lehman Brothers where the simultaneous closing out of these contracts threatened to create chaos both in the Lehman bankruptcy and in the derivatives market generally.[131] The situation was controlled to an extent by netting and by the inability of many counterparties to retrieve assets to satisfy their claims. In a different scenario, it was the possibility to seize collateral that led to the collapse of AIG. When AIG's financial situation deteriorated, its counterparties forced the insurer to begin posting collateral which led the company to liquidate assets, thereby destroying going-concern value which is something that the US bankruptcy regime is meant to avoid.[132]

With the experience gained from the financial crisis, the development of the law through the FDIA and OLA regimes has brought a shift in the objectives of the resolution of banks and systemically important non-bank financial institutions. Thus, whilst the Bankruptcy Code is designed generally to rehabilitate the debtor or to maximise the going-concern value, a resolution regime may allow the regulators to give consideration to the impact on the economy and financial markets. Thus, the systemic risk exception in the FDIA is an example of taking market impact into account where the main concern is to avoid bank runs.[133] Another example comes from the OLA regime which relies for its implementation on a determination based on the likely impact of a covered financial company's default on financial markets and the economy.[134] This allows regulators to take action in a regulatory resolution regime that is intended to limit the impact of the troubled institution's insolvency on entities other than its creditors or on the economy and the financial system.

Summing up, Adams notes that the derivative safe harbours are oriented towards termination and liquidation, particularly for parties where derivatives make up a large part of their assets base and cannot be explained in the light of the objectives of either the bankruptcy regime or any of the resolution regimes. In this situation, he considers that the focus on liquidation, termination and acceleration of the derivatives safe harbours 'stands out as an oddity' and demands 'justification'.[135] Just how much of an oddity the safe harbours are will be assessed in the following part dealing with insolvency law principles and just how much justification can be demanded will be considered in the last part dealing with the effect of public policy and state goals on US insolvency law.

131 *In re Lehman Brothers Holdings Inc. et al.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010).
132 AYOTTE & SKEEL (2009) 494.
133 12 U.S.C. § 1823(c)(4)(G). See JANGER & POTTOW (2015) 156.
134 See section 203 of the Dodd-Frank Act.
135 ADAMS (2014) 108.

6.4.1 Principles Upheld by US Insolvency Law

US insolvency law has implemented principles intended to safeguard the objectives of the insolvency regime. These principles have already been referred to at the beginning of this chapter. In this part, a more detailed analysis of two of these principles, namely the automatic stay and the 'assume-and-reject' power, will be made as these principles are deemed to be central in the fulfilment of the rationale of US bankruptcy law and its tendencies to protect the interests of the debtor. This is followed by an assessment of the impact of the exercise of close-out netting rights on these principles.

Principles

When a debtor files a bankruptcy petition, it immediately enjoys the protection of the Bankruptcy Code's automatic stay provision, which is intended to restrain creditors from acting individually to enforce their claims over the property of its estate. Congress created this mechanism with the intention to serve as 'one of the fundamental debtor protections provided by the bankruptcy laws.'[136] Since this protection could have had an unfair impact on the rights of creditors, Congress deemed that the automatic stay would not extinguish creditors' rights, but would merely prevent enforcement 'pending an orderly examination of the debtor's and creditors' rights.'[137] Roe and Adams consider that the concept behind the automatic stay is that the whole firm can be worth more than the sum of its parts. The stay is designed to determine whether the firm has going-concern value, to allow the firm to realise such value and then to distribute the proceeds to the widest possible group of creditors. Other bankruptcy rules are in place to ensure that a firm that has going-concern value is kept intact. Thus, fraudulent conveyances of the debtor's assets before bankruptcy for inadequate value can be returned to the bankrupt business and *ipso facto* clauses that make the filing of the bankruptcy an event of default are generally unenforceable.[138]

The automatic stay is also beneficial to creditors, even if this is not its primary target. According to Edwards and Morrison, because a firm in distress is akin to a scarce resource, without some form of control of its assets, creditors would have unlimited rights of access to the debtor's property.[139] The result is that the first creditors to utilise the debtor's resources would be satisfied, while those who enforce their claims later might end up with nothing. This effect has been referred to as the 'grab-race' in part 6.1.

136 S. Rep. No. 989, 95th Cong., 2d Sess. 54(1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5840.
137 H.R. Rep. No. 595, 95th Cong., 2d Sess. 342 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6298.
138 ROE & ADAMS (2015) 377.
139 EDWARDS & MORRISON (2005) 95.

Without the protection of the automatic stay, creditors who are first in time will be satisfied 'even if the [debtor's] resource[s] would have more value per user if exploited in a more restrained manner.'[140] Similarly, the automatic stay prevents secured creditors from seizing collateral when the debtor fails to repay the loan and subsequently files a bankruptcy petition.[141] According to Baird and Jackson, removal of collateral, especially collateral that is essential to the firm's survival, may benefit the individual secured creditor to the detriment of other creditors since it dismembers a firm and destroys its value.[142]

The second basic principle relates to the debtor's or trustee's power to assume or reject contracts, subject to court approval. According to Lubben, the debtor's agreements can be seen as partially outside the estate, because the debtor must make the initial decision to either 'reject' or 'assume' each of its contracts and unexpired leases. If a debtor assumes a contract, the contract comes entirely into the estate and the debtor becomes bound by its terms. If a debtor rejects a contract, it commits a breach and the non-debtor party is left with a pre-petition claim for damages.[143] This power may have negative repercussions on the debtor's creditors. Roe and Adams note that whilst the automatic stay is intended to preserve going-concern value, the debtor's right to reject or assume contracts has incentives for the debtor to break up its portfolio of contracts along self-interested lines, keeping the winners and rejecting the losers. The debtor is obliged to pay in full contracts that it assumes. If it is presumed that the debtor will assume winning contracts, it means that it is paid in full value whilst it would only pay proportionately the rejected contracts. The debtor would thus maximise the value of the package to itself, at the same time preserving going-concern value.[144]

Impact of Close-out Netting under the Safe Harbours

In order to fully grasp the impact of the safe harbours, consideration should be given to the rationale for the bankruptcy law protection that it undermines. It was considered by Congress that the automatic stay gives companies attempting to restructure their debt under Chapter 11 'a breathing

140 EDWARDS & MORRISON (2005) 106.

141 11 U.S.C. § 362(a)(3). Since, as a general rule, secured parties are not listed in the exceptions of part (b) of this section, it is clear that the automatic stay applies to both unsecured parties, as to judgment liens, and secured parties, as to the repossession of collateral. See 11 U.S.C. § 362(a)(5). However, outright transfers of collateral appear to escape the provisions of the automatic stay if the transfer took place before the commencement of bankruptcy proceedings, they could be subject to the ninety-day suspect period unless the transaction qualifies under the safe harbours, *e.g.* as a repo transaction.

142 BAIRD & JACKSON (1984) 106.

143 11 U.S.C. § 365(a), (b)(1) & (g). See LUBBEN (2009) 66.

144 11 U.S.C. § 507 & 1129(a)(9). See ROE & ADAMS (2015) 384.

spell and time to work constructively with [their] creditors.'[145] According to Edwards and Morrison, by protecting the debtor's assets from creditors' individual actions, the stay 'avoids dismemberment of a firm with going-concern value and facilitates a collective proceeding in which the parties (debtor and creditors) can negotiate the terms under which the firm will continue as a going concern.'[146] Schwarcz notes that the safe harbours were not, in their current form, originally part of the Bankruptcy Code and became part of the Code, at least in part, through path dependence.[147]

It is not difficult to understand that the legislative treatment of the safe harbours is the antithesis of all that the two principles considered above stand for. The safe harbours promote the individual pursuit of claims and the seizing of collateral up to the eve of bankruptcy without the need to observe any suspect periods. This special treatment basically extends to the whole of the derivatives market on account of the wide definitions of swap agreements and on account of the blanket provisions of FDICIA. The negative effect of the treatment of close-out netting under the safe harbours on going-concern value and on debtor rehabilitation is easy to perceive. The exercise of close-out netting rights under the safe harbours therefore takes away the powers from the bankruptcy trustee to organise the rehabilitation or liquidation of the debtor and gives an unrestricted measure of self-help to the netting creditor to pursue its individual claims. The 'reject-and-assume' powers of the bankruptcy trustee are also rendered ineffective since the safe harbours transfer this power to the netting creditor who is given the option to exercise its close-out netting rights, which it is assumed will be exercised depending on whether closing out is favourable to itself.

Perhaps of a lesser impact is the exercise of close-out netting rights under resolution regimes. Thus, under FDIA the FDIC is empowered to stay individual creditor action for a limited period of sixty days,[148] but there is no general power to stay contracts. In particular, the FDIC cannot keep contracts in force while preventing counterparties from exercising their rights under those contracts. Thus, unlike bankruptcy courts, the FDIC cannot stay 'self-help' remedies such as liquidation of collateral, for most contracts. However, the FDIC as receiver has broad powers to disaffirm or repudiate contacts within a reasonable time.[149] As they cannot compel performance under the repudiated contract, the affected counterparty remedies are limited to *ex post* damages.[150] According to Bliss and Kaufman, unlike the general corporate bankruptcy stay that keeps contracts in place,

145 H.R. Rep. No. 595, 95th Cong., 2d Sess. 174 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6135.

146 EDWARDS & MORRISON (2005) 95.

147 SCHWARCZ (2015) 702. This aspect of path dependence will be discussed in the next part of this chapter.

148 12 U.S.C. § 1823(c)(2)(C).

149 12 U.S.C. § 1823(e)(1) & (2).

150 12 U.S.C. § 1823(e)(3).

this procedure is more akin to the close-out mechanism found in derivatives contracts.[151] When the FDIC unilaterally terminates a contract, it creates a claim that has the status of a general creditor. Thus, while most contracts, with the exception of QFCs, are automatically stayed by courts in the event of a corporate bankruptcy, the opposite situation obtains in the event of a bank's insolvency. It would thus seem that the exercise of close-out netting rights is more in tandem with the principles adopted by FDIA albeit with a temporary suspension on their applicability, than they are with the principles of the automatic stay and the 'assume-and-reject' powers enshrined in the Bankruptcy Code.

6.4.2 Effect of State Goals on US Insolvency Law

It is evident that the steps involved in a close-out netting process under US law, namely the termination of a financial contract, the exercise of set-off rights and the selling of collateral provided by the debtor to secure the contract are inconsistent with the broader goals of Chapter 11 of the Bankruptcy Code, such as debtor value maximisation, the rehabilitation of the debtor and equal treatment of creditors. The recognition of close-out netting provisions is also inconsistent with the scope of Chapter 7 liquidations insofar as concerns the priority ranking of creditors for the distribution of proceeds and the privileged position given to netting creditors. In this respect, Peck, Mokal and Janger explain that bankruptcy proceedings are designed to allocate loss from the insolvency in a predictable manner. The statutory priority regime, which according to these authors reflects the history of bankruptcy as it has developed in the US and the judgment of Congress as to the proper ranking of claims, is critical to achieve this by channelling losses away from creditors placed in a higher ranking to those placed in a lower one and is the model against which any deviations from the norm should be measured. Financial contracts, including close-out netting provisions inherent to these contracts, escape that measurement altogether by being excluded from the priority scheme applicable to all other creditors.[152]

The question to be considered in this part is whether the 'deviations from the norm' in relation to the privileged treatment of netting creditors under the safe harbours can be based on any public policy or state goals being pursued by Congress which could serve to justify them. In general, two principal reasons have been propounded for this special treatment. One is the traditional reason related to the need to prevent systemic risk associated with financial contracts. This is the reason propounded by Congress in relation to the various expansions of the safe harbours for which the exercise of close-out netting rights in relation to financial contracts was given

151 BLISS & KAUFMAN (2006a) 12.
152 PECK *et al.* (2011) 3.

special treatment.[153] The second reason, or rather 'non-reason' given its nature, is advanced by critics of the vast expansion of the safe harbours and relates to the notion of path dependency, implying that each safe harbour itself served as justification for the next safe harbour and as such was not tied to any 'conscious' public policy reason being pursued by Congress. Each of these reasons will be considered below.

One of the proponents of the systemic risk theory is Krimminger, former Senior Policy Advisor at the FDIC. Krimminger states that Congress expanded protection of the ability to terminate and set off claims under certain financial contracts 'because protection of these contractual rights is viewed as crucial to protect the viability, not only of individual counterparties, but of the marketplace as a whole.' Krimminger states that protected contracts must be actively traded in the financial markets and subject to the risks of fluctuating values inherent in those markets. For these reasons, he argues, Congress has repeatedly sought to protect participants and the markets 'from the delays inherent in normal bankruptcy processes and the impact this could have on values, liquidity, and access to pledged collateral.'[154] This proposal has been met with scepticism. After citing the various declarations made by Congress to justify the successive expansions of the safe harbours, Mooney notes that although most academics would agree that some special treatment for financial contracts is needed, it is commonly argued that the current treatment is 'far more generous than would be necessary to address the overarching goal of the safe harbors: the reduction or elimination of systemic risk.'[155] It has also been noted that since financial counterparties may simultaneously claim the debtor's assets upon filing for bankruptcy, there is a risk of a run on the debtor possibly leading to a liquidity shortage that has the potential to spill over to other firms and markets and cause widespread instability in financial markets.[156] The opt-out from the bankruptcy regime creates an opportunity for financial institutions to restructure standard financial contracts to look like derivatives agreements.[157] In other words, the safe harbours may merely substitute one kind of systemic risk for another.

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153 Both the Bankruptcy Code safe harbours and FDIA focus on the systemic risk associated with financial contracts but whilst bankruptcy focuses on the 'risk to capital markets if financial contracts cannot clear too quickly', bank resolution focuses on bank runs, *i.e.* 'the danger of the contracts clearing *too* quickly.' See JANGER & POTTOW (2015) 156. Thus, whilst the Bankruptcy Code seeks to protect liquidity under certain instruments by exempting them from the automatic stay and avoidance powers, bank resolution law seeks to preserve the asset value of a bank by the transfer of its financial contracts to a solvent party.

154 KRIMMINGER (2006) 5.

155 MOONEY (2014) 251.

156 EDWARDS & MORRISON (2005) 105; FAUBUS (2010) 806.

157 KEATH HANCE (2008) 765.

The second reason given for the development of the safe harbours, and which is itself a form of criticism of the systemic risk theory, is that Congress followed a path dependency approach, whereby a preceding type of safe harbour served to justify later expansions without the legislator questioning the justification of the original safe harbour in the first place. Schwarcz and Sharon state that legal path dependence occurs 'when an initial path effectively blinds lawmakers to alternative paths.'[158] In such circumstances, it may be difficult to trace whether the development of the enforceability of close-out netting is the result of a conscious decision made by the legislator to pursue a defined public policy in the light of the applicability of US insolvency law. Scwarcz and Sharon note that the origin of the path dependence was the limited exemption, included in the bill that became the Bankruptcy Code, for the allegedly fragile commodities futures market. The untested justification for the initial exemption, namely concern about systemic risk, was reiterated by the President's Working Group on Financial Markets for subsequent expansions of the safe harbour, often without questioning the merits of the expansions to protect against systemic risk. According to Schwarcz and Sharon, this reflects an 'informational blindness', fuelled by both the complexity of derivatives and uncertainty over how systemic risk operates. Pressure was also brought to bear by powerful derivatives industry groups led by ISDA, whilst Congress was not presented with equally powerful opposing views.[159]

Mokal is another proponent of this path dependency theory. Mokal considers that this argument is without merit. He considers that in normal times, when markets are stable, close-out and asset realisation immunities are privately beneficial for individual counterparties who can terminate contracts and liquidate the collateral they hold in a value-preserving manner. By contrast, the simultaneous liquidation of significant quantities of contracts and of collateral triggers a collective action problem as contract and collateral values collapse. Mokal notes that in a path dependency approach, national policymakers are pushed down the favoured path through comparisons with sophisticated markets and through regional competitiveness considerations, leading to legislative changes with no necessary reference to either social welfare or fairness considerations.[160]

158 According to Schwarcz and Sharon, this blindness can occur when legislative patterns are locked in due to informational and political burdens. Informational burdens arise when the choice of one legislative course of action makes future assessments of alternative courses harder since policymakers become used to the 'normal' state of affairs. Political burdens are created when groups or institutions sympathize with earlier legislative choices and exert their influence to maintain the approach created by those choices. See SCHWARCZ & SHARON (2014) 1723.

159 *Ibid.* 1741. Schwarcz and Sharon note that the leading organisation that presented Congress with opposing views was the National Bankruptcy Conference. *Ibid.*

160 MOKAL (2015) 73.

It is important to bear in mind that the Congress was not specifically targeting the protection of close-out netting when establishing the safe harbours, rather Congress was protecting the exercise of contractual rights in relation to designated financial contracts. This makes it more difficult to understand the specific protection of close-out netting provisions in the light of the rationale of US bankruptcy law. Thus, close-out netting provisions are only protected if they form part of an eligible financial contract so that ordinary loans and other credit facility contracts which may also contain close-out netting provisions do not get any special treatment. It is also to be noted that specific focus on the protection of close-out netting rights started to be given in the 1990s by virtue of the enactment of sections 560 and 561 of the Bankruptcy Code, and of section 403 of FDICIA. This came at a time when the lobbyist movement led by ISDA was putting pressure on legislators to enact legislation protecting close-out netting provisions on the basis of party autonomy on the premise that, *inter alia,* this is required to curtail systemic risk.[161] There is little support for the systemic risk argument brought by Congress to justify the protection of the exercise of contractual rights under the safe harbours, in particular by the proponents of the path dependency theory. Adams notes that what drove Congress to create and expand the safe harbours is optimism about free markets, lack of understanding about complex new instruments and the fear of systemic risk.[162] When several financial crises finally drew attention to the derivative safe harbours in the early 2000s and particularly during the crisis of 2008, the emerging criticisms of the safe harbours also focused on systemic risk contributed by the safe harbours to the financial system by exacerbating the financial distress of major financial institutions and undermining market controls that might work to mitigate such distress.

6.5 Preliminary Conclusions

US law has been classified as an eclectic legal system, meaning that it bears elements of both the common and civil law systems. It also operates a dual system of state law and Federal law. The regulation of close-out netting is no exception to this legal set-up. Outside of a bankruptcy situation it is regulated wholly by the applicable state law. Within bankruptcy the applicable state netting law still applies but only within the confines of the mandatory provisions of the Bankruptcy Code. The US Bankruptcy Code has been generally classified as pro-debtor. This is reflected in various of

161 Schwarcz & Sharon refer to the leading role taken by ISDA in the drafting of the safe harbours, in particular its involvement in the drafting of BAPCPA and its close collaboration with the President's Working Group on Financial Markets. These authors also suggest that the derivatives industry proliferated, in part, on account of the US law safe harbours. See SCHWARCZ & SHARON (2014) 1741.

162 ADAMS (2014) 102.

its provisions, notably in its objective of giving the debtor a second chance and of preserving going-concern value for the benefit of the debtor by the adoption of principles such as the automatic stay. It gives the debtor the choice whether to file for rehabilitation or liquidation under the Bankruptcy Code and it normally entrusts the estate in the hands of the debtor.

Two main federal rules have been analysed which regulate the protection given to close-out netting provisions in an insolvency situation, namely section 560 of the Bankruptcy Code in relation to swap agreements and section 403 of FDICIA in relation to bilateral netting. Both provisions are clearly exceptions to the pro-debtor tendencies of US bankruptcy law. The protection of close-out netting under the US safe harbours forms part of the wider protection of contractual rights, a full list of which is provided in the definition of 'master netting agreement' in section 101(38A) of the Bankruptcy Code, and which apply in relation to widely-defined financial contracts concluded between financial participants. Not all safe harbours specifically cover this full list of protected rights. The initial safe harbours were intended to give protection to the close-out of contracts in order to crystallise open trading positions and did not stipulate the protection of contractual netting rights. It was only with the enactment of sections 560 and 561 that specific reference was made to off-set and netting in relation to the close-out of a financial contract. In order to solve the uncertainty created by the fact that not all safe harbours specifically refer to the protection of netting rights, section 403 of FDICIA was enacted to cover netting in relation to all the safe harbours, including those already covering close-out netting. This provision protects a close-out netting provision 'in accordance with its terms', reminiscent of the standard of protection under the EU's Financial Collateral Directive. However, it should also be noted that section 403 is made subject to a few exceptions, most notably to the powers of the FDIC to disaffirm or repudiate contracts under the FDIA regime[163] and under the OLA regime.[164]

It may be argued that prior to 1990 Congress did not have in mind the specific protection of close-out netting provisions. Indeed, the initial expansion of the safe harbours focused on specific and narrowly defined financial contracts where the focus was on closing out open positions, rather than reducing counterparty exposure through close-out netting. This is reinforced by the limited number of parties that originally benefited from the safe harbours, thus the recognition of close-out netting provisions was not foremost in Congress' mind. Considerations of recognition became more evident with the development of the derivatives market which relies on the enforceability of close-out netting provisions for its core functionality. It may be noted that section 560 of the Bankruptcy Code continues to refer to the exercise of close-out rights (in the form of termination, acceleration and liquidation) as separate from the exercise of netting rights, even though

163 12 U.S.C. § 1821(e).
164 12 U.S.C. § 5390(c).

netting under this section is specifically rendered enforceable in relation to termination, acceleration or liquidation. The separation of close-out from netting is even more pronounced in section 561 of the Bankruptcy Code which refers in the alternative to 'the termination, liquidation, or acceleration of *or* to offset or net termination values […]' when recognising the enforceability of master netting agreements. A counterargument to this is that the reference to 'or' may be more cosmetic than consequential since the netting is of 'termination values' and hence presupposes that a termination has already taken place.

Of a different category is the bilateral netting provision of section 403 of FDICIA which is possibly unique in focusing solely on the recognition of netting arrangements concluded between financial institutions, as opposed to the safe harbours which recognise close-out and netting as part of other contractual rights which have been granted special protection. In this case the law speaks of contractual payment obligations and contractual payment entitlements which are 'terminated, liquidated, accelerated, *and* netted', thus indicating that these elements are considered as part of the same single contractual mechanism. This provision grants virtually full recognition to close-out netting provisions within its scope of application, evidenced by the reference to 'in accordance with, and subject to the conditions of, the terms of any applicable netting contract.' Although the scope of application of this provision is wide and covers any contract concluded by defined financial institutions, it does not cover contracts concluded between parties, at least one of whom is a non-financial institution.

First Sub-question

It has been argued that it is difficult to consider the right of netting protected under the safe harbours as a mere contractual enhancement of ordinary set-off. Contrary to the law regulating netting, the exercise of ordinary set-off rights remains, to a significant extent, subject to the insolvency law principles and may only be exercised within the confines of section 553 of the Bankruptcy Code, the most notable restriction being that both claims should have arisen pre-petition and, for certainty sake, before the ninety-day suspect period. Any variations from the confines of section 553 require the approval of the courts. It is arguable that the concept of insolvency close-out netting may have little in common with that of ordinary set-off rights, except for the fulfilment of the mutuality requirement, and may have developed as a completely separate concept based as it is on the notion of protection of contractual rights in relation to financial contracts. Thus, whilst all insolvency principles and restrictions still apply to ordinary set-off unless the exceptions of section 553 of the Bankruptcy Code apply or unless the set-off is allowed through court intervention, the exercise of contractual close-out netting rights under the safe harbours is exonerated from observance of these principles or restrictions, save when exercised in bad faith.

Court intervention is also still prevalent for the exercise of ordinary set-off rights and is particularly crucial if the rights subject to set-off have arisen on the eve of bankruptcy or post-bankruptcy. Court intervention is also required to facilitate the ordinary set-off process where the requirements of maturity or liquidity of obligations have not been fully met, but where an estimation by the court is possible. On the other hand, if close-out netting arrangements set out the contractual modalities for calculating close-out amounts, then these will be enforceable when exercising close-out netting rights under the safe harbours without the need to resort to the courts for an estimation and without the need to observe any suspect periods. The preliminary conclusion in relation to the first sub-question raised in the Introduction is therefore that close-out netting under US law does not stem from ordinary set-off but has been created as a separate concept, possibly to suit the requirements of the derivatives market industry. This conclusion will be examined further in Part III.

Second Sub-question

It is not difficult to envisage that the safe harbours are an exception to the traditional rationale of US bankruptcy law which is aimed towards the discharge of the debtor and the preservation of the going-concern value of the enterprise, even if more recent developments have seen a shift in maximising creditor recoveries through the pre-pack option. Criticism has been levelled at the idea that the safe harbours are required to protect against systemic risk. Indeed, the FDIA and OLA resolution regimes were, in part, put in place to combat the systemic risk potentially arising from the individual credit resolution regimes and to impose restrictions aimed to achieve a more equitable balance between the protection of creditors' claims and the pursuit of goals such as market stability and the protection of depositors. Because it is difficult to justify the remaining safe harbours on grounds of systemic risk, the path dependency theory has gained popularity among academic circles which fail to accept that Congress could justify each expansion on the basis of systemic risk, but who conclude that each expansion was itself used as justification for subsequent expansions on the basis of what has been termed informational blindness. In the end and as a preliminary conclusion of the second sub-question, it may be difficult to reconcile the protection given to close-out netting under the safe harbours in pursuit of a particular goal or public policy followed by Congress which, except in relation to the application of resolution regimes, has chosen to give virtually full protection to close-out netting from the application of insolvency law principles.

Third Sub-question

The financial crises in the US heralded new considerations of systemic risk and led to the adoption of two resolution regimes, first the FDIA regime for insured banks and subsequently the OLA regime for systemically important non-bank financial institutions. A primary goal of these resolution regimes is to promote the stability of the financial system by preventing market contagion. They therefore impose brief stays on early termination rights that would otherwise be triggered by the commencement of receivership or conservatorship. These brief stays are intended to stop a run on banks and preserve the value of the assets of the systemically important institution for the benefit of the institution's stakeholders and the economy in general.

Resolution measures have brought mixed effects on the exercise of close-out netting rights. The FDIA regime applicable to banks has had the effect that banks are no longer subject to the ordinary bankruptcy regime and close-out netting rights pertaining to banks are exercisable only under the provisions of FDIA. Under FDIA the exercise of close-out netting rights may be temporarily suspended to allow for the taking of resolution measures whilst partial transfer of QFCs are prohibited. The same restriction and safeguard apply in relation to systemically important non-bank financial institutions under the OLA regime although in this case a determination of the systemic importance of the institution has to take place before the FDIC may exercise its powers in relation to close-out netting provisions. The type of brief stays imposed on close-out netting provisions and the restriction on partial transfers are reminiscent of the type of restrictions or safeguards imposed under the English and French regimes. One difference is the bail-in regime which appears to operate differently in the US. A detailed comparative analysis of the impact of the resolution regimes of the three selected jurisdictions on close-out netting provisions will be made in Chapter 7.

Part III

Comparative Analysis and the Influence of the Legal Systems

7 Comparative Analysis of the Close-out Netting Regimes of England, France and the US

7.1 Uniformity of the Close-out Netting Concept

Having focused on the theoretical aspects of close-out netting in Part I of this research and on the legal close-out netting regimes of England, France and the US as representative jurisdictions of the common, civil and eclectic legal systems in Part II, this chapter conducts a comparative law analysis of these three national regimes. The comparative analysis is intended to provide conclusive replies to the three sub-questions raised in the Introduction namely in relation to (i) the influence of national set-off rules on the development of close-out netting, (ii) the effect of national insolvency laws and state insolvency goals on the recognition of close-out netting provisions and (iii) the convergence or otherwise in the type of restrictions introduced by bank resolution regimes on the exercise of close-out netting rights. The conclusions of this chapter will then form the basis for analysing and replying in Chapter 8 to the main research question on the influence of the legal systems of England, France and the US in the extent of recognition given to close-out netting provisions.

The Giovannini Group noted in its November 2001 report on cross-border clearing and settlement arrangements in the EU that '[w]here netting has been introduced by […] legislation, its availability is normally limited to specific products, types of counterparty or forms of contractual documentation. This leads to the need for detailed analysis of the relevant features of a transaction before it can be safely assumed that netting will be available.'[1] Taking into consideration this concern expressed by the Giovannini Group and prior to considering the three sub-questions referred to above, the first issue to be analysed in this chapter is whether the concept of close-out netting is a uniform concept under the three regimes. In theory, the close-out netting mechanism consists of a three-step process which generally permits the non-defaulting party to terminate or accelerate the outstanding transactions, calculate the gains and losses on the basis of market values or replacement costs, and net amounts due to produce a single net balance payable by one party to the other. It is also typically concluded between financial institutions since close-out netting has the characteristics of a remedy to prevent loss resulting from financial contracts. An examination of the regulation of insolvency close-out netting under the selected regimes has, however, revealed that whilst the end result or economic outcome of

1 See Barrier 14, EUROPEAN COMMISSION 2001 Giovannini Group First Report.

the determination of a single amount is fairly constant, close-out netting may not be a coherent concept across the jurisdictions.

The comparative analysis of the concept of close-out netting will be divided in two parts, the first dealing with the constitutive elements of close-out netting and the second with the personal and material scope of application of the netting regimes. First, a comparative assessment is made whether and how the three-step process, comprising the rights of (i) close-out, (ii) valuation and (iii) netting, which make up the close-out netting mechanism have been incorporated in the laws of the selected regimes. In the second part dealing with the scope of application of national close-out netting regimes the main issue to be considered is whether, notwithstanding that the personal and material scope varies from one jurisdiction to the other, it can be said that at its core the close-out netting mechanism is restricted to the financial markets.

7.1.1 Constitutive Elements of Close-out Netting

The UNIDROIT Principles on the Operation of Close-out Netting Provisions provide in paragraph 19 that close-out netting 'is best described in functional terms, i.e., by reference to a result', this being the single net payment obligation. Accordingly, the UNIDROIT Principles consider the three steps constituting the close-out netting mechanism, namely termination, valuation and determination of a net amount, to be merely functional steps which describe what happens in practical terms but it is not necessary for all these steps to be present for the result, *i.e.* the single net payment obligation, to be achieved.[2] This approach implies that there are various ways in which close-out netting may be achieved and national laws do not necessarily have to follow a particular process to grant recognition to close-out netting provisions. It is the scope of this part to ascertain whether the three-step process of termination, valuation and determination of a net amount, which commands fairly wide acceptance in doctrine, all constitute elements of the close-out netting concept under the laws of the three selected jurisdictions.

Constitutive Elements

A reading of the literature used for this research gives the impression that whilst European authors' views appear to converge on the idea of a three-step process of the close-out netting mechanism, no such clear approach is taken by US authors. Admittedly, the European approach could have been influenced by the EU's FCD which is based on the three-step process. Notwithstanding this possible influence, the implementation of the English and French close-out netting regimes is sufficiently diverse to merit a comparative exercise between these two regimes for the purposes of the

2 See paragraphs 32 & 33, UNIDROIT 2013 Close-out Netting Principles.

main question. It is expected that the major difference will be the comparison with the US safe harbours which are expressed in a more unique style and language.

Under English law the primary source for determining the elements of the concept of close-out netting is arguably the definition of 'close-out netting provision' provided by regulation 3(1) of the FCAR which for the most part reproduces the definition of the same term in Article 2(1)(n) of the FCD. In terms of the FCAR definition, a close-out netting provision is activated by the occurrence of an enforcement event and leads to (i) the acceleration or termination of outstanding obligations, (ii) the establishment of amounts representing each original obligation's estimated current value or replacement cost and (iii) the netting or setting off of the amounts due so that a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party. English law doctrine is virtually consistent in identifying the aforementioned three steps in the close-out netting process.[3] On the other hand, the definition of close-out netting arrangements in section 48(1)(d) of the Banking Act 2009 which refers to the calculation of the actual or theoretical debts for the purpose of enabling them to be set off against each other or be converted into a net debt, places more emphasis on the elements of calculation and determination of a net amount. Since this definition is meant to serve the specific purposes of resolution measures under the Banking Act where it is considered important that contracts are not terminated to allow the resolution authority to adopt any resolution measures deemed necessary, it may not be suitable for the purposes of analysing comprehensively the constitutive factors of close-out netting under English law. Still it is noteworthy that the element of valuation is given prominence in this definition, thereby confirming that it is considered by the English legislator as one of the constitutive elements of close-out netting.

Whilst the elements of close-out netting under English law are regulated in the definitions of the FCAR, under French law these are regulated in the main text of article L.211-36-1 of the Financial Code. This article is striking by the lack of reference to the term close-out netting as a notion as it refers instead to its constitutive elements. Thus, paragraph I of this article, which sets the main rule granting recognition to close-out netting provisions, refers to only two aspects of close-out netting namely to the termination element and to the possibility of setting off the outstanding obligations. In fact, this is the idea imparted by Bonneau *et al.* who appear to consider two steps in the close-out netting process, namely close-out consisting of the early termination of the contract and the netting which permits the set-off of reciprocal debts, adding that these are evaluated in accordance with the terms of the contact. Thus, according to these authors, the valuation aspect is embedded

3 For instance, see YEOWART *et al.* (2016) 602; ANNETTS & MURRAY (2012) 269.

in the other two steps.[4] In paragraph II, however, reference is made twice to the enforceability of the contractual modalities of termination, valuation and set-off, making it clear that in the mind of the French legislator these are the three constitutive elements of the close-out netting concept. The reference in paragraph II to *all* contractual modalities of termination, valuation and set-off stipulated in agreements and master agreements implies that the various modalities of termination may also include acceleration of obligations and the reference to the various modalities of set-off also implies other forms of determining a close-out amount, such as by novation netting.[5]

US law generally lacks a unified concept of close-out netting, so that close-out and netting are considered as two separate rights which may be related to a single contract. It may therefore appear that under US law there is conceptually a reversal of steps in the sense that there should first be a contract in place for close-out and netting to be considered as unified under that contract. The approach taken by the US legislator under the safe harbours of the Bankruptcy Code is to protect contractual rights generally. Ultimately, however, the contractual rights referred to in for instance section 560 of the Bankruptcy Code are in fact the type of rights exercised under a close-out netting provision, namely termination and its variants liquidation and acceleration on the one hand, and, on the other, the offset or netting of 'termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements.' This provision combines a number of factors which in the end may signify that the concept of close-out netting is not much different from that envisaged in the other two jurisdictions. The most prominently featured element is that of termination, liquidation and acceleration which is an expression of all the modalities of cancellation of a contract. Second, the reference to termination values or payment amounts is an acknowledgement that a valuation of outstanding obligations should take place to obtain a close-out amount. Finally, the modalities of offset or netting of termination amounts are specifically mentioned in relation to the termination, liquidation or acceleration of the obligations thus creating the necessary contractual link between these three aspects of close-out netting. However, unlike the other two jurisdictions which have more clearly specified the three constitutive elements in their respective laws, it is only by way of interpretation that the valuation aspect can be assumed under US law. This is also the case with section 403 of FDICIA which only mentions the termination aspect, including liquidation and acceleration, and the netting aspect, and then adds the wording 'in accordance with, and subject to the conditions of, the terms of any applicable netting contract'. It is again a matter of interpretation that leads to the assumption that any valuation of outstanding obligations is covered by the terms 'subject to the conditions'

4 See BONNEAU *et al.* (2017) para. 933.
5 See in this respect GAUDEMET (2010) para. 464.

of the netting contract, given that in the standard master agreements such a condition would constitute an important aspect of the close-out netting mechanism. Thus, valuation may be considered either as an essential or, at least, as an ancillary aspect of another constitutive element, *i.e.* of close-out.

Ancillary Issues

Although not considered as constitutive elements, other ancillary issues are analysed below as they help set the confines of operation of close-out netting on the basis of the three-step process and clarify further the recognition granted to close-out netting provisions under the three selected regimes. These issues relate to (i) the requirement for close-out netting to form part of a financial collateral arrangement, (ii) the role given to set-off in the determination of a close-out amount and (iii) whether the single agreement concept is necessary to ensure connexity between the obligations which are subjected to netting.

(i) Part of a Financial Collateral Arrangement

Under the FCAR, the English legislator grants protection to a close-out netting provision if it forms part of a financial collateral arrangement. This stems from the definition of a 'close-out netting provision' in regulation 3(1) of the FCAR which is limited to 'a term of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part.' As already noted, this state of affairs may be a consequence of the fact that the FCAR implement the EU's FCD which applies in the context of financial collateral arrangements. This, and the conviction of English authors that close-out netting will be upheld independently of the FCAR protection provided it fulfils the requirements of insolvency set-off, may have restricted the protection granted by law to close-out netting provisions.

On the other hand, French law has implemented the FCD by separating the part on the protection of close-out netting from that on harmonisation of the rules of financial collateral arrangements. The former is regulated under article L.211-36-1 and the latter under article L.211-38 of the Financial Code. In this way the French legislator has avoided the situation whereby the protection of close-out netting provisions is restricted to those provisions forming part of a financial collateral arrangement. This situation does not preclude that any collateral provided for the purposes of setting off with amounts due is taken into account for the purposes of a close-out netting provision.[6]

6 See article L.211-38, I and IV of the Financial Code.

Similarly, under US law a close-out netting provision does not have to form part of a financial collateral arrangement in order to receive protection under the safe harbours. It is interesting, however, to note the approach taken by some US authors in relation to the importance of credit enhancement for a close-out netting provision. Thus, Bliss and Kaufman make the generic statement that 'closeout and netting perform different economic functions, and both are in practice tied to collateral.'[7] Janger *et al.* go a step further and state that close-out netting constitutes three steps, namely termination, set-off and sale of collateral.[8] These comments may reflect a special position which credit enhancement has under the US safe harbours. However, it is doubtful whether the sale of collateral must be considered as an essential constitutive element of close-out netting given that under US law it is not necessary that close-out netting forms part of a collateral arrangement in order to receive the safe harbour protection. The emphasis being made on the sale of collateral may reflect the fact that credit enhancement is embedded in the various definitions of the types of agreement protected under the safe harbours. This is, for instance, the case in relation to section 560 of the Bankruptcy Code dealing with swap agreements. However, the reference to credit enhancement is included in such definitions in the sense that any credit enhancement may be taken into account for the purpose of determining a net amount, and not in the sense that the existence of credit enhancement is necessary for close-out netting to receive protection under the safe harbour.

(ii) Role Given to Set-off

All three regimes refer to the modality of set-off to achieve a single payment amount. Thus, the English FCAR definition of 'close-out netting provision' in its regulation 3(1) refers to both the netting and set-off modalities for achieving a single close-out amount. Set-off is therefore one, of other, modalities by which a single net amount may be determined under the FCAR. The reference to set-off in this context is to contractual set-off, rather than insolvency set-off.[9]

Set-off is stated to be the main modality to determine a close-out amount under article L.211-36-1 of the French Financial Code, but article L.211-36-1, II of the Financial Code itself gives recognition to *all* contractual modalities of termination, evaluation and set-off so that a wider meaning to set-off should be given in this context.[10] The situation may have been different under the old law where the former article 1290 of the Civil Code

7 BLISS & KAUFMAN (2006) 57.

8 JANGER *et al.* (2014) 3.

9 See ANNETTS & MURRAY (2012) 277; YEOWART *et al.* (2016) 448.

10 This wider interpretation of set-off conforms with the term given by French jurists to close-out netting, namely '*résiliation-compensation*' and in keeping with the notion that the French legislator used existing French concepts to construe the close-out netting concept.

applied automatically in cases where reciprocal debts under terminated contracts are liquid, fungible and due.[11] This is contrary to the view under English law where the established view is that the set-off modality referred to under close-out netting is that of contractual set-off. Following the recent changes to the French Civil Code where set-off is no longer of a mandatory nature, it is probably the case that both laws converge on this point.

Section 560 of the US Bankruptcy Code refers to both offset and netting for the purpose of determining a single payment amount when related to the termination, liquidation or acceleration of a financial contract. It has been seen that offset is considered separate from ordinary set-off under US law and is a type of contractual set-off.[12] On the other hand, there is a remarked absence of a reference to offset under both the definition of 'netting contract' in section 402 of FDICIA and the general rule on bilateral netting in section 403 of FDICIA, which could be either an indication that offset no longer has a role to play in close-out netting or, arguably the more correct view is that FDICIA uses more modern terminology in conformity with the idea that there are various modalities by which a single net amount can be achieved, which may include offset.

(iii) Single Agreement Concept

A question arises whether it is necessary under the three selected regimes for obligations affected by a close-out netting agreement to be linked to a single financial agreement to ensure some form of connexity between them.

According to the definition of 'close-out netting provision' in regulation 3(1) of the FCAR, the close-out netting provision must form part of a financial collateral arrangement. It is not clear whether this constitutes a requirement to incorporate the single agreement concept to ensure recognition of a close-out netting provision, which serves to tie all obligations subject to the close-out netting provision together so as to avoid any cherry-picking under national law, or whether the reference is simply a coincidental implementation of the FCD and should not be given any ulterior motive. Although there is not sufficient clarity on the terminology used to state that a single agreement is postulated as a requirement for the protection of any close-out netting process, it is nonetheless a pre-requisite for protection of close-out netting provisions under the FCAR.

In terms of article L.211-36-1, II of the French Financial Code the modalities of termination, valuation and set-off *may* be governed by an agreement or master agreement ('*Ces modalités peuvent être notamment prévue par des conventions ou conventions-cadres.*'), thereby indicating that it is not a necessity that a close-out netting provision is associated with a contract

11 According to Gaudemet, once obligations are terminated and given a monetary value under a close-out netting provision, it is possible that set-off automatically applies under the old law. See GAUDEMET (2010) para. 470.

12 See Chapter 6.2.

and therefore with the single agreement concept. Although it appears to be discretionary whether the three constitutive elements of close-out netting should derive from a contract, according to doctrine a close-out netting provision should be linked to either the same contract or to various contracts through global netting.[13]

The situation is slightly different under US law where the understanding of US authors is that close-out and netting are separate rights which become related when incorporated in the same contract. The safe harbours protect contractual rights and do not specifically protect a close-out netting provision which renders it difficult to examine the single agreement concept. An indication is given by section 560 of the Bankruptcy Code that close-out and netting are to be tied to a contract when it refers to 'offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of *one or more swap agreements*.' Strictly speaking, this is not a reference to the single agreement concept but constitutes a way of linking the separate contractual rights of close-out and netting to the same contract or contracts. Similar to the other safe harbours under the Bankruptcy Code the second part of section 560 defines the term 'contractual right' to include also rights arising from industry association rules or bylaws, from common law and law merchant, among others, 'whether or not evidenced in writing', which implies that the contractual rights of close-out and of netting will be protected not only if they are linked to a contract, but also if they are linked through other means such as industry bylaws or market practice. Section 403 of FDICIA, on the other hand, provides that:

> '[T]he covered contractual payment obligations and the covered contractual payment entitlements […] shall be terminated, liquidated, accelerated, and netted in accordance with, and subject to the conditions of, the terms of any applicable netting contract.'

Rather than a requirement for the existence of a single agreement, this constitutes a reference to the standard 'in accordance with the terms' of the netting agreement. Ultimately, US law does not directly impose the single agreement concept to link the obligations under the close-out netting provisions especially since the contractual rights being protected may emanate either from contractual or non-contractual sources.

In sum, it can be stated that it is the same close-out netting concept, in its various contractual modalities, that is being protected by the three selected jurisdictions. It is therefore arguable that close-out netting is not solely a functional process with an economic outcome, *i.e.* the determination of a single net payment sum, but under the law of the three selected jurisdictions it is a concept constituted of the three elements of (i) termination, (ii) valuation and (iii) determination of a net amount. Only in the case of

13 See JURISCLASSEUR (2013) Fasc. 2050, para. 84-86.

English law is there a requirement that the close-out netting forms part of a financial collateral arrangement, as otherwise the other two jurisdictions only mention the requirement (in non-mandatory terms) that the obligations emanate from an agreement or master agreement. However, the terminology used does not go so far as to require the single agreement concept which is common to standard master agreements such as the ISDA master agreement. Hence, this remains an issue determined by market practice and does not appear to be enshrined in the law of the selected jurisdictions. Finally, it has been seen that in all three regimes, set-off is a modality to determine a close-out amount, with the common understanding being that the set-off modality is that of contractual set-off, rather than insolvency set-off which would typically require the fulfilment of certain conditions.

7.1.2 Scope of Application

As a general rule, the delimitation of the scope of application of a national netting regime should reflect the type of risks that the legislator is seeking to avert, in particular since the enforceability of close-out netting provisions ultimately entails important derogations from the application of mandatory insolvency law principles, at times to the detriment of other existing creditors. It would therefore seem logical that national laws limit the application of this risk mitigation mechanism to certain financial parties operating in the financial markets, for instance the derivatives market where the fluctuating values of financial instruments and the typical hedging of investment portfolios renders these financial instruments particularly vulnerable to the consequences of insolvencies.[14]

ISDA, as lead proponent on the promulgation of national netting laws, has advocated that the identification of relevant national policy is of utmost importance for the adoption of netting legislation, in particular since netting legislation involves a regime which derogates from the normally applicable insolvency rules, so that these may only be justified in relation to certain eligible parties and in certain specific contexts. ISDA asserts, however, that whilst it may be appropriate for the legislator to limit certain types of financial activity, it may not 'make sense to limit the effectiveness of close-out netting by reference to types of market participants.'[15] This assertion is based on the assumption that systemic risk reduction should benefit all market participants without providing much economic justification for this assumption. On the other hand, when discussing the importance of the enforceability of bilateral close-out netting, Recital (14) of the EU Financial

14 For this reason, loans and deposits are typically excluded from the scope of application since they are not subject to rapid changes in value or the volatility of markets, albeit deposits may receive special protection under bank resolution regimes. See UNIDROIT 2013 Close-out Netting Principles, para. 90. These Principles, however, also list instances where loans and deposits may be taken into account. *Ibid.*

15 ISDA 2006 Guide for Legislators, 3 & 4.

Collateral Directive provides that '[s]ound risk management practices commonly used in the financial market should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis […].' The emphasis of the FCD is therefore that, even though there may be limitations on the types of financial market counterparties receiving protection, it is important that *all* financial obligations entered into between specified counterparties are protected. Although at opposing sides of the spectrum, both the ISDA declaration and the FCD indicate the necessity of maintaining a significant link with the financial markets, either through the personal or the material scope of the close-out netting law. It will be examined in this part whether any of these two opposing stances is reflected in the selected regimes or whether a totally different approach has been implemented which could even result in severing the link with the financial markets.

The scope of application is probably the issue which creates most discrepancies between national laws since arguably no netting law is exactly the same in relation to its scope of application. Although the various discrepancies will not be analysed in detail, the focus of this part will be to ascertain whether a strong link has been maintained with the financial markets or whether a wider scope has been made applicable. In the former case, it may be easier to justify the derogations granted to close-out netting on the basis of state insolvency goals related to systemic risk considerations. A wider scope may entail the consideration of other grounds such as competitiveness or possibly the influence of the wide application of set-off laws which may have perpetrated itself upon close-out netting regulation. These considerations related to the scope of application will be analysed in part 7.3.1 of this chapter in order to understand the rationale for the scope of application of close-out netting regulation by reference to the state insolvency goals.

The protection of close-out netting under the English FCAR is closely modelled on the FCD for its material scope which widely refers to 'relevant financial obligations' covered by a title transfer or a security type of financial collateral arrangement in relation to cash, financial instruments including shares, bonds and other securities giving rights to acquire shares or bonds, or credit claims. The material scope of the FCAR therefore conforms with the stance recommended by Recital (14) of the FCD considered above. However, the personal scope of the FCAR is significantly wider than both the FCD and ISDA stances and covers also close-out netting provisions to which *both* parties are corporates or 'non-natural persons' in terms of regulation 3 of the FCAR. The ISDA stance to cover any type of market participant is deemed to be a reference to a *financial* market participant. Under English law, however, the parties can be any type of corporate who have entered into financial collateral arrangements in relation to 'relevant financial obligations', also widely defined. In terms of the FCAR consultation document this extended personal scope was considered to be consistent with the 'overall policy objectives' of English law, that is to reduce systemic risk and to increase the efficiency of the markets, and that it furthermore simplified implementation by avoiding the need to introduce 'elaborate definitions'.[16] Gullifer does not agree with the declaration made by the court *obiter dictum* in the *Cukurova* case that the wider the scope of the FCAR, the better the protection against systemic risk,[17] since it implies that the FCAR could cover straightforward business financing arrangements, such as a loan made to a company secured by a charge over its bank account, which she argues should be subject to the normal insolvency regime.[18] The wide scope of application may also stem from the general idea expressed in the FCAR consultation document in relation to the implementation of Article 7(2) of the FCD where it is stated that there were no restrictions to the implementation of close-out netting provisions under English law[19] which is deemed to be a reference to the wide applicability of insolvency set-off law.

In relation to the French close-out netting regime, article L.211-36-1 of the Financial Code permits the close-out netting of financial instruments listed in article L.211-1 of the Financial Code relating to financial securities and financial contracts, and covers also options, futures, swaps and all forward contracts listed in article L.211-36, II of the Financial Code. Eligible persons include regulated institutions and public bodies as provided in the EU's FCD. However, it has been seen that article L.211-36-1 of the Financial Code reflects a partial opt-out permitted by Article 1(3) of the FCD. Thus, if one of the parties to the close-out netting arrangement is not an eligible person, then the arrangement must regard financial obligations resulting from the aforesaid financial instruments. In this case, the non-eligible person could be any corporate or an individual. French law therefore adopts a restricted material scope where one of the parties is a non-eligible person but goes beyond the FCD and ISDA stances in relation to the personal scope, in particular by extending protection to arrangements of individuals contracting with an eligible person, which position would be difficult to justify on systemic grounds and could be deemed to conflict with Article 1(2)(e) of the FCD excluding natural persons from its personal scope.[20] On the other hand, if both parties are eligible persons, then the wider FCD material scope becomes applicable which is not limited to transactions involving financial instruments but covers also financial obligations

16 HM TREASURY 2003 FCAR Consultation Document, para. 2.3.

17 *R (on the application of Cukurova Finance International Ltd) v HM Treasury* [2008] EWHC2567 (Admin) at [96].

18 GULLIFER (2017) 274.

19 HM TREASURY 2003 FCAR Consultation Document, para 4.6.

20 In *Private Equity Insurance Group' SIA v Swedbank' SA* (Case C-156/15) delivered on 10 November 2016 a preliminary reference was made to the European Court of Justice by the Latvian Supreme Court on whether the implementation of the FCD in national law could include physical persons in its personal scope. Unfortunately, the European Court did not give its ruling on this question since it deemed the question to be hypothetical and declared it inadmissible.

resulting from all contracts related to payment of cash or title transfer. However, it is important to note that the law still refers to financial obligations, as opposed to commercial ones, so that there are excluded commercial operations resulting from the sale of goods or provision of services which are not financial operations.[21] The more restricted material scope in the case of arrangements concluded with non-eligible persons is in keeping with the idea expressed in Chapter 5.2.2 that the close-out netting mechanism is considered by a number of French jurists as a form of indemnification which is typically available in the financial markets to cover for losses that may be suffered by financial market players on account of the default of their counterparties.[22] Unlike English law which protects financial arrangements also concluded between corporates, the close-out netting regime under French law does not apply at all if none of the parties to a financial agreement is an eligible person so that whilst English law maintains a link with the financial markets through its material scope, French law does so through its personal scope.

The US safe harbours are based on a three-pillar structure since they seek to protect the contractual rights of stipulated parties to particular financial contracts[23] from the application of the Bankruptcy Code. Contractual rights include the ability to terminate and set off or net payment or delivery obligations. In 2005 BAPCPA added the notion of 'financial participant'[24] to the already long list of protected parties, with the result, according to Morrison and Riegel, that the law now exempts 'sophisticated' financial participants from the reach of the automatic stay and other mandatory principles of insolvency law.[25] The fact that section 560 of the Bankruptcy Code, which grants protection to contractual rights of swap agreements, has been widely construed to cover effectively all derivative contracts and any party thereto, not only financial parties, may have brought about the elimination of the three-pillar construction on which the safe harbours were traditionally built. Of wider scope are the provisions of FDICIA, notably sections 402 which in the definition of 'netting contract' refers to the more general term of 'financial institutions' and the material scope is stated to be the netting of 'present or future payment obligations or payment entitlements'.[26] However, as pointed out by Bliss, the Federal Reserve's criteria stipulated in Regulation EE for determining whether a financial institution qualifies under the FDICIA definition is that the 'firm must be a trader or

21 JURISCLASSEUR (2013) Fasc. 2050, paras 74 & 77.

22 See GAUDEMET (2010) para. 468.

23 11 U.S.C. §§ 362(b)(6), 555, 556, 559, 560 & 561. Covered contracts and protected parties have been defined in Chapter 6.3.

24 11 U.S.C. § 101(22A). It has been seen in Chapter 6.3 that the size requirements for a financial participant are $1 billion of gross national principal outstanding or $100 million of gross marked-to-market value of outstanding positions.

25 MORRISON & RIEGEL (2015) 650.

26 12 U.S.C. § 4402(14)(A)(i).

dealer, rather than an end user, and meet a minimum size requirement.'[27] In relation to the material scope, Morrison and Riegel state that these extensions of protection contracts may have shifted the focus of the Bankruptcy Code to form over substance and it may be now more difficult for judges to draw a boundary line between financial contracts and ordinary loans.[28] Since the material scope has been widened to this extent, must the link to the financial markets then be established on the ground of the parties to the agreements? Bliss appears to think so when he states that the US safe harbours provide no protection in relation to contracts entered into between financial institutions and non-financial institutions.[29] However, it may be counterargued, at least theoretically, that certain important definitions under section 101 of the Bankruptcy Code, such as that of swap participant and financial participant, are so wide as to cover any party, whether financial or not, although the minimum size requirement should be met to qualify as a financial participant. Thus, although in form the idea is that the safe harbours are only operative in respect of stipulated financial contracts entered into by financial parties, in substance the definitions are so wide and flexible in their interpretation that arguably the link with the financial markets is rather tenuous and the stance taken goes beyond those proposed by ISDA and the FCD.

This comparative analysis has confirmed the global tendency for the existence of significant discrepancies in the scope of application of national close-out netting regimes. The discrepancies exist even in relation to the English and French regimes which are meant to implement the FCD and are therefore based on a common source. Indeed, whilst English law has been faithful in implementing the material scope of the FCD, it goes beyond its personal scope by protecting arrangements concluded between two corporates so that a link with the financial markets is kept through its material scope only. French law, on the other hand, applies a wider material regime if the arrangement is concluded by two eligible persons and a narrower material regime if one of the parties is not an eligible person, such as a corporate or an individual, so that it depends on the situation whether the stronger link is maintained through the material or the personal scope. Also, English law requires that the close-out netting provision should form part of a financial collateral arrangement and French law does not. As a matter of form, US law appears to maintain a link with the financial market through both the material and personal scope but in substance the flexibility and wide remit of the definitions of eligible parties and contracts may have significantly widened both the personal and material scope of application beyond the realm of the financial markets. As a result of these discrepancies, the comparative analysis does not give an indication whether the link to

27 BLISS (2003) 55. See Regulation EE, 12 C.F.R. § 231.

28 Morrison and Riegel cite examples how an ordinary loan may be replicated by a combination of financial contracts. MORRISON & RIEGEL (2015) 657.

29 BLISS (2003) 55.

the financial markets is most likely to be in relation to either the personal or material scope of application. One common trait is that all three jurisdictions have demonstrated a tendency to widen the scope of application of their close-out netting regimes, albeit in varying ways. It will be considered in part 7.3 of this chapter whether this widened scope of application is intended to attain a particular target chosen by the national legislator in pursuit of a declared state insolvency goal.

7.2 Relationship with Set-off

It was stated at the beginning of this research that the netting technique, in its various forms, is a relatively novel mechanism based on party autonomy which combines pre-existing legal concepts and adapts them to financial market practices.[30] In this respect, the UNIDROIT Principles acknowledge that '[b]roadly speaking, close-out netting is often understood as resembling the classical concept of set-off applied upon default or insolvency of one of the parties.'[31] Both concepts of set-off and netting achieve the same economic result, namely the payment of a single amount following the aggregation of values of two or more obligations owing reciprocally between the parties, but the UNIDROIT Principles confirm that the close-out netting concept 'encompasses additional elements, providing, for instance, for the netting of obligations not yet payable', which may be an obstacle under ordinary set-off rules.[32] It is the scope of this part to compare the constitutive elements of the concepts of set-off and close-out netting with a view to establishing whether set-off law has influenced the recognition of close-out netting under the laws of the three selected jurisdictions. The analysis of this part will serve to provide replies in the Preliminary Conclusions to the first sub-question of the Introduction.

7.2.1 Scope for Contractual Enhancement

All three selected regimes refer to set-off in their netting laws. This is done in the context of considering set-off as a modality for the determination of a single amount once a contract has been terminated and outstanding obligations evaluated, which aspect has been termed by the UNIDROIT Principles as the 'set-off of all due and payable obligations in the classical sense.'[33] However, different from the 'classic' set-off, the reference in these three regimes is to the contractual modality of set-off which may be selected by the parties as one type of modality for determining a close-out amount.

30 See Chapter 1.2.
31 UNIDROIT 2013 Close-out Netting Principles, para 3.
32 *Ibid.*
33 *Ibid.* para 36.

Dalhuisen notes that set-off is commonly considered as a means of extinguishing a debt and that on account of its exposure reduction characteristics it may also be considered as a risk management tool, capable of acquiring other features. He states that the enhancement of set-off would usually occur by contract and could result in the elimination of certain of its basic requirements, giving rise to other structures that become separate from set-off in the traditional sense. Dalhuisen draws an interesting distinction between those jurisdictions where set-off is mandatory and those were it is subject to notification or invocation, stating that contractual variations on the set-off principle so introduced are likely to be more favourably considered in countries where the set-off is subject to notification and considered a legal act which may imply the parties having a say in the set-off method, different therefore in principle from countries where the set-off is always automatic, even outside bankruptcy.[34] Following the enactment of specific netting legislation in the three selected jurisdictions, it can be safely stated that close-out netting is, to varying degrees, protected across all three jurisdictions. The link with set-off is also present in all three jurisdictions and it will be analysed in this part whether any traces of the distinction made by Dalhuisen between mandatory and voluntary set-off regimes can be detected in the three selected jurisdictions.

English Law

English law operates a mandatory, self-executing insolvency set-off regime whose rules cannot be contracted out of as a matter of public policy. Typical of other traditional set-off regimes, insolvency set-off under English law has a wide scope of application, covering practically all types of obligations, except those arising from tort or damages, and any type of counterparty, including corporates and individuals. The self-executing nature of insolvency close-out netting under English law implies that once the conditions for the application of insolvency set-off have been met, these apply notwithstanding any close-out netting provision applicable to those obligations. The question therefore arises whether insolvency close-out netting based on regulation 12(1) of the FCAR constitutes a sufficiently clear stand-alone concept.

Although, as seen in more detail in Chapter 4.2.1, a number of requirements should be met for insolvency set-off to become applicable, insolvency set-off applies with sufficient flexibility as to share a number of features with close-out netting, which in other jurisdictions may not be readily the case. From the point of view of the fulfilment of requirements, for both insolvency set-off and close-out netting the dealings must be strictly mutual[35] and neither will apply if a party has notice of a specified insol-

34 DALHUISEN (2019) 387.

35 It has been seen, however, in Chapter 4.2.1 that English law recognises the assignment of claims and cross-guarantees to fulfil the mutuality requirement for set-off purposes.

vency event occurring in relation to the other and in the case of close-out netting this is extended to constructive knowledge. It is permitted for both concepts that sums due in the future or payable on a contingency are taken into account and valued, though this is not without some uncertainty for insolvency set-off as seen in Chapter 4.2.1. On the other hand, the more significant distinguishing features of close-out netting are the ability to convert non-monetary obligations such as obligations to deliver or transfer securities into monetary ones, the avoidance of uncertainty relating to the valuation of future and contingent debts by an insolvency practitioner and the ability to terminate or accelerate obligations in relation to executory contracts. It may seem at first glance that there is not much contractual enhancement pertaining to close-out netting given the flexibility with which insolvency set-off operates.

Prior to the enactment of the FCAR in 2003, insolvency close-out netting was governed by the provisions of insolvency set-off as then regulated by the Insolvency Regulations 1986. This approach was confirmed by the 1993 Statement of Law on 'Netting of Counterparty Exposure' issued by the UK Financial Law Panel considered in Chapter 4.2.2. It is to be noted, that in the *British Eagle* case it was stated *obiter* that netting arrangements not deemed to conform with insolvency rules could be rejected as an attempt to 'contract out' of mandatory provisions of law. Indeed, prior to the enactment of the FCAR in 2003, the justification of these netting arrangements involved lengthy argumentation devolving around the applicability of insolvency law axioms,[36] and this notwithstanding the 1993 Statement confirming that close-out netting worked under English law. The FCAR brought a significant amount of certainty in relation to the contractual enhancement features of close-out netting, though it is still the case that close-out netting continues to be overshadowed by the mandatory provisions of insolvency set-off.

In relation to English doctrine, it is invariably the case that literature treats insolvency set-off and close-out netting together. According to Yeowart *et al.*, this close relationship between the two concepts:

> 'is not a coincidence because close-out netting provisions in agreements governed by English law have been modelled upon principles that underpin rules 2.85 and 4.90, IR 86, and their predecessors, and the definition in the FCARs reflects this. This was necessarily the case because insolvency set-off under English law is mandatory and it is not possible to contract out of it.'[37]

This close association may have led to the wide personal scope of the English close-out netting regime to include arrangements between two corporates, as already indicated in the first part of this chapter. It may have

36 See in this respect DERHAM (1991) 539.
37 YEOWART *et al.* (2016) 224.

also led to the specific disapplication or modification of certain provisions on insolvency set-off under regulations 12(4) and 14 of the FCAR, even though the general interpretation is that also other insolvency set-off provisions do not apply.[38]

The view has been discussed in Chapter 4.3 that insolvency set-off rules may replace close-out netting in circumstances where the conditions of regulation 12(2) of the FCAR have not been fulfilled, such as where there is constructive knowledge of an impending insolvency.[39] This view, however, is not convincing on account of the separate requirements of the two notions. Thus, it is not possible under insolvency set-off rules to terminate outstanding obligations in an executory contract. This is only possible in the case of close-out netting. Therefore, in the eventuality that the solvent party is deemed to be aware of the pending insolvency, then this situation should lead to the disapplication of the close-out netting provision rather than to its replacement by insolvency set-off. Indeed, the only possibility for insolvency set-off to replace close-out netting is when its conditions of application materialise before the termination phase of a close-out netting provision since the ability to terminate is only possible in close-out netting.

There are therefore sufficient technical aspects, borne out of the notion of contractual enhancements, which have shaped the concept of close-out netting as a stand-alone concept and the link with set-off should, also technically speaking, be only of one contractual modality amongst others to determine the close-out amount once the termination and evaluation phases of close-out netting have been concluded. However, on account of the mandatory nature of insolvency set-off, it has to be ensured that a close-out netting provision is drafted in a resilient manner so that insolvency set-off does not replace the contractual terms.[40] This should be simpler to achieve in the case of executory contracts which will require the termination or acceleration of the outstanding obligations, since this feature is only permitted under the party autonomy aspects of close-out netting as recognised by the FCAR.

French Law

Since its incorporation into the Napoleonic Code, France operated a mandatory set-off regime until this was converted to a voluntary one following the 2016 amendments. The automaticity of the extinguishment of two debts was intended for set-off to operate as a means of payment. Notwithstanding the reversal of the automaticity under articles 1347 and 1348 of the French

38 See Chapter 4.3.

39 For instance, this is one of the interpretations given by Ho and analysed in Chapter 4.3. However, Ho's preferred interpretation is that in the circumstances where the requirements of insolvency set-off are fulfilled, they will always take precedence over the recognition of close-out netting. HO (2012) 351.

40 See GULLIFER (2017) 386.

Civil Code, it is still dealt with under the heading of extinguishment of obligations and hence *prima facie* is still considered as a means of payment. This reversal was possible, in part, due to the fact that set-off is not considered to be a public policy rule under French law and could be waived.[41] In addition, the extinctive effect is deemed to take place when all conditions of legal set-off have been met, and not from the date when it is invoked.[42] This may serve to reconfirm its characteristic as a means of payment. Contrary to English law, French law does not have a concept of insolvency set-off, but recognises three types of set-off, namely legal, judicial and contractual, which may apply both in and outside of insolvency, subject to provisions of law.

Arguably, since there is no notion of insolvency set-off under French law and parties could waive their right of set-off, close-out netting could develop as a separate branch of law which borrowed from the set-off concept but was not overshadowed by it. The need was felt by the French legislator to grant protection to close-out netting provisions more than a decade before the obligation to transpose the FCD arose. The special features of close-out netting which are particularly suited as a loss indemnification mechanism for the financial markets[43] were therefore long appreciated and constantly finetuned, whilst the concept of set-off did not change from the time of its insertion in the Napoleonic Code until 2016 when the automaticity was removed. What is also peculiar to French law is that the legislator resorted to known concepts when legislating on the close-out netting mechanism, still reflected in the term '*résiliation-compensation*', which in itself indicates that whilst there is a link with set-off, close-out netting is a broader concept. In addition, although article L.211-36-1, I of the Financial Code refers only to set-off as a modality to determine a close-out amount,

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41 Pichonnaz states that the non-public order nature of set-off was accepted in a law of 1880 and its renunciation may take place either after the fulfilment of the conditions of legal set-off as at this point it is deemed that the creditor accepts to pay without reservation, or before the fulfilment of the conditions and in this case the effects of compensation do not materialise. Pichonnaz also notes that in time it became accepted that if it was not invoked before the judge, then it is presumed to have been renounced. PICHONNAZ (2001) 412 & 514.

42 See Chapter 5.2.1. Although in practical terms it may also be considered as a security of payment up to the amount covered by the set-off, it does not create any real right and for this reason has been termed as a 'simplified means of payment'. However, it is still considered as an 'indirect security' using conventional means, thereby bypassing the regulation of the types of security recognised by law which are considered burdensome to secure certain types of transactions. See DELOZIÈRE-LE FUR (2003) 39.

43 Gaudemet explains that having terminated the obligations under the first phase of close-out netting, it is only possible to consider the determination of a single payment amount if this is considered as corresponding to the prejudice caused by one of the parties in the early termination of these obligations and relative contracts. It therefore represents the contractual indemnity for the breach of the terminated contracts. According to Gaudemet, the loss is normally, but not solely, indemnified by paying the replacement value of the terminated contract in accordance with market conditions. GAUDEMET (2010) para 468.

it is generally understood that this does not imply that only set-off may be considered, but rather any modality which the parties may agree in terms of their agreement or master agreement.

A comparison between the scope of application of the two concepts is consistent with their intended rationale. There is no restriction imposed on the material and personal scope of application of set-off, being a means of payment, so that in terms of article 1347 of the Civil Code it relates to the extinction of reciprocal obligations between two persons. Thus, set-off applies in respect of any type of party and any type of obligations so long as these are fungible, certain, liquid and due, and are mutually owed between the parties. Close-out netting, being a loss indemnification mechanism, applies in respect of financial obligations concluded between parties, at least one of whom is an eligible person. Given the flexibility of fulfilment of the requirements for set-off under French law, the similarity between set-off and close-out netting is substantial. Thus, whilst fulfilment of the reciprocity requirement is strictly necessary for both concepts, it is possible for parties to set contractual valuations of their claims in relation to non-fungible obligations, even in the case of delivery obligations and to satisfy the requirement of certainty of obligations by recording the same in their contractual arrangements, at least in relation to contractual set-off. Differences between set-off and close-out netting apply in the case of obligations which are not yet liquid or payable, or in respect of future obligations. Whilst it is only possible to set off claims when the obligation has become due and payable, even with the intervention of the courts, in close-out netting it is possible to terminate or accelerate the maturity of the obligations and to contractually agree on their valuation. As in the case of English law, the termination or acceleration aspect is the most distinguishing feature between the two concepts.[44] The manner of enforceability of set-off and close-out netting is another distinguishing feature. Thus, whilst in the case of close-out netting, article L.211-40 of the Financial Code does not impose any condition for the enforceability of close-out netting arrangements, article L.622-7 of the Commercial Code provides that pre-insolvency claims should be connected for set-off to be permitted following the commencement of insolvency proceedings.[45] In terms of article L.622-17 of the Commercial Code post-insolvency claims may be set off if this is necessary for the continuation of the failing business.

Auckenthaler states that in the end close-out netting does not, strictly speaking, correspond to any specific juridical or conventional concept regulated by French law. Close-out netting permits diverse ways in which obligations concluded between two parties can be reduced to a single net payment, of which set-off is just one modality. Thus, if the parties have agreed to create a new obligation following the extinction of the old obli-

44 See in this respect BONNEAU (2017) para 934.

45 This derogation of the set-off of connected obligations, according to Gaudemet, confirms the nature of set-off as a means of payment. See GAUDEMET (2010) para 504.

gations through the novation modality, then there is no set-off.[46] Bonneau *et al*, consider that the sole fact that close-out netting is regulated by its own separate law, namely article L.211-36 of the Financial Code, implies it derives from its own original source of law which is excluded from the application of the law on collective procedures.[47]

It may be stated with sufficient certainty that close-out netting may be considered as a stand-alone concept which is not fettered in its application by any mandatory provisions of set-off and this notwithstanding the substantial similarities between the two concepts, in particular with contractual set-off. Set-off remains a possible contractual modality, amongst others, for determining a single amount, in particular in relation to global netting where it is foreseen as the sole modality to achieve a single global payment. Thus, although French law originally operated an automatic legal set-off, this was not considered a public policy rule as in the case of English law and such circumstances may have permitted the separate development of close-out netting prior to the implementation of the FCD. This development was also necessitated by the need felt by the financial community to have in place a loss indemnification mechanism for the financial markets. This may be the reason why French law, contrary to English law where the personal scope of application may be extended to agreements concluded by two corporates, always requires that at least one of the parties is an eligible person so as to maintain a link with the financial markets. On the other side of the coin, since French law extends the personal scope to agreements concluded between an eligible person and a physical person, it does not seem that considerations of systemic risk could have been the main, or at least the sole, drive for the development of close-out netting.

US Law

Similar to current French law, under US law the exercise of the ordinary right of set-off is a voluntary act of a non-public order nature which must be invoked by the creditor. Ordinary set-off is described by the US Department of Justice in its Attorneys' Manual as 'an equitable right' of a creditor to deduct a debt it owes to the debtor from a claim owing to it by the debtor.[48] Morton notes that in judicial proceedings, since set-off has to be invoked by the defendant, it is essentially procedural so that the defendant '*must* set up in his answer' any claim arising out of the same or different transaction or occurrence giving rise to the plaintiff's claim. However, Morton admits that

46 AUCKENTHALER (2013) para 70. In an earlier article, Auckenthaler states that netting is a combination of juridical mechanisms, whether based on the set-off concept or not, which permit the establishment of a single net amount. AUCKENTHALER (2001) para 3.

47 BONNEAU (2017) para 931.

48 See US ATTORNEY MANUAL Part 65.

what may have initially started as a procedural step may have today taken on 'characteristics of substance'.[49]

In contrast with the other two selected regimes, US law operates a rather inflexible notion of ordinary set-off in an insolvency situation. Ordinary set-off applies in respect of any type of obligations held by the same parties in the same capacity. As a general rule, ordinary set-off is governed by the insolvency law principles of the automatic stay, prohibition of creditor preferences and fraudulent transfers. By way of an exception, in terms of section 553 of the Bankruptcy Code the automatic stay is lifted for ordinary set-off in respect of connected and mutual claims which arose before the commencement of bankruptcy proceedings provided the ninety days' rule for suspect periods has been observed. Similar to the other two regimes, there is no possibility to exercise termination in relation to ordinary set-off which is affected by the automatic stay so that only pre-bankruptcy transactions may be set off against each other without court intervention. Besides the mutuality requirement mentioned above, it has been seen in Chapter 6.2.1 that ordinary set-off must also satisfy requirements related to liquidity, certainty and maturity and if not fulfilled, a solution may need to be sought through court intervention. In addition, whilst it is possible to accelerate the maturity of debts to permit the ordinary set-off of obligations that are certain or have accrued but are not yet liquidated, the courts typically prohibit the set-off of debts which are contingent on some event which has not yet occurred.

Notwithstanding the restricted flexibility in the application of the ordinary set-off concept, it is possible to conceive that the US legislator could have developed the close-out netting concept on the basis of contractual enhancements to set-off. However, it was established in Chapter 6.2.2 that it is difficult to establish this link with ordinary set-off since close-out netting has developed under the different notion of the safe harbour protection of contractual rights, which may include close-out and netting as two separate rights. Indeed, initially only the close-out aspect was protected under the safe harbours in the form of the rights to terminate, accelerate and liquidate, which rights are extraneous to the ordinary set-off concept, until in the 1990s section 560 of the Bankruptcy Code extended the protection to netting and offset rights on the basis of the same safe harbour provisions that protected close-out. This would indicate that the US legislator was not contemplating the ordinary set-off concept when considering the contractual enhancement aspects of close-out netting, but was gradually adding to the list of contractual rights to be protected under the safe harbours, until the various aspects of close-out netting started to appear together first in the said section 560 of the Bankruptcy Code and then more specifically in section 403 of FDICIA. Thus, contrary to French law where the legislator resorted to known concepts upon which to build the close-out netting concept, the US legislator built a new stand-alone concept which evolved

49 MORTON (1976) 376.

from the safe harbour protection of individual contractual rights related to financial contracts. This is also evident in the way in which the legislator created the new contractual right of 'offset' as a protected right under the safe harbours rather than as an offshoot of the ordinary set-off concept.

Three Different Outcomes

This part has sought to compare two particular aspects related to the set-off concept in the three selected jurisdictions, the first being whether close-out netting evolved as a contractual enhancement of set-off and the second whether the rules governing set-off in any way still apply or still shape the application of close-out netting. Arguably, the comparative analysis could not have demonstrated more diverse outcomes for the three selected jurisdictions. One commonality shared by the three jurisdictions is that the termination aspect pertains only to close-out netting and is a special feature not derived from set-off. But on other aspects, these jurisdictions have taken diverse approaches. Thus, under English law close-out netting originally derived from the set-off principle and its flexible way of operation. Indeed, with insolvency set-off being a mandatory self-executing principle, it was initially advised by English authors that close-out netting provisions should be drafted as close as possible to fall within the precepts of insolvency set-off in order to ensure its enforceability. *Ad hoc* close-out netting law was only enacted to fulfil the EU's membership obligation of transposing the FCD. It has been noted that insolvency set-off, being mandatory and self-executing, still overshadows it and, as will be seen in the succeeding part of this chapter, English authors state that it is advisable to draft the close-out netting provisions in a way which render them as different as possible from insolvency set-off, possibly devising a different contractual modality to determine a close-out amount such as novation to avoid the possibility that insolvency set-off rules take precedence. Whilst under French law the close-out netting concept was built on the existing notions of termination and set-off thereby indicating already that close-out netting goes beyond set-off since it incorporates also termination, the French legislator developed a separate close-out netting regime well before the transposition of the FCD. Over the years the legislator finetuned this regime to meet the specialised needs of the financial market, thereby manifesting its appreciation that the risks of this market cannot be adequately protected by set-off. Finally, the US legislator has chosen to develop the close-out netting concept under the separate notion of safe harbour protection of contractual rights of financial contracts. The rather inflexible nature of ordinary set-off may have contributed to this separation, also evidenced by the fact that the US legislator created the notion of offset as a contractual right under the safe harbours and did not rely on ordinary set-off. This, coupled with the lack of literature in the US discussing the link of close-out netting with ordinary set-off which can be found in respect of the other two jurisdictions, may indicate that there was never meant to be a link between the two and that close-out netting was from its inception considered to be developed on the basis of the safe harbour protection. These observations will be used in the part on Preliminary Conclusions of this chapter to reply to the first sub-question of the Introduction.

7.2.2 Recognition 'In Accordance With Its Terms'

Having considered from a comparative point of view the attributes and the scope of application of the concept of close-out netting and its interaction with set-off, the comparative analysis will next focus on the extent of recognition given to close-out netting provisions from two perspectives, first whether a close-out netting provision can be enforced 'in accordance with its terms' as advocated by Principle 6(1) of the UNIDROIT Principles and Article 7(1) of the FCD and, second, whether any mandatory rules continue to restrict this contractual freedom. This analysis will be restricted to the applicability of mandatory rules of set-off and insolvency law[50] and will not include consideration of the effect of resolution measures which will be considered separately later in this chapter. The areas of set-off and insolvency law have been singled out by the UNIDROIT Principles as being particularly problematic in the enforcement of close-out netting provisions in some jurisdictions,[51] though these Principles also acknowledge that:

> 'It is obvious, however, that close-out netting provisions would never be allowed to trump certain other fundamental rules, such as the rules relating to misrepresentation and fraud to the detriment of the counterparty, its creditors or the insolvent estate.'[52]

This part will first consider the role played by contractual freedom under the main close-out netting rules of the three selected regimes and will then consider any restrictions imposed by their set-off and insolvency law regimes on the exercise of party autonomy. The observations made in this part will be used to provide replies in the Preliminary Conclusions to the first and second sub-questions of the Introduction.

'In Accordance With Its Terms'

Under English law, the recognition of close-out netting provisions is influenced by a combination of the transposition of the FCD and the application of certain rules governing insolvency set-off. Regulation 12(1) of the FCAR provides that a close-out netting provision which forms part of a financial

50 It is thus not within the scope of this analysis to consider general contact rules which must be complied with, such as contractual capacity, or other national laws which may in any way restrict or effect the exercise of party autonomy.
51 See UNIDROIT 2013 Close-out Netting Principles paras 110 & 115.
52 *Ibid.* para 112. This is being stated in relation to Principle 7(2).

collateral arrangement takes effect 'in accordance with its terms' notwithstanding the commencement of winding-up or reorganisation procedures. This provision is clearly based on Article 7(1) of the FCD. On the other hand, sub-regulation (2) of the same regulation provides an exception to this rule in cases where the financial collateral arrangement or the relevant financial obligation was created at a time when the solvent party was aware or should have been aware of the commencement of winding-up or reorganisation procedures. This may have been influenced by the provisions on insolvency set-off then applicable under the former rule 4.90 of the Insolvency Rules 1986 (also applicable today) which disallows set-off if there is actual knowledge of an impending insolvency. Subject to the conditions imposed by regulation 12(2) of the FCAR, a close-out netting provision is enforceable 'in accordance with its terms' only if it falls within the scope of the FCAR, implying that the close-out netting provision should form part of a financial collateral arrangement. Beyond the scope of the FCAR, a close-out netting provision does not benefit from this standard of party autonomy but becomes subject to the mandatory provisions of insolvency set-off. Given the prevalent view in English doctrine that insolvency set-off law is sufficiently flexible to grant the necessary protection to close-out netting provisions, the English legislator chose to transpose faithfully but narrowly the provisions of the FCD with the result that recognition of contractual freedom is restricted to close-out netting provisions forming part of financial collateral arrangements, with the further restriction imposed by the legislator of the absence of knowledge or constructive knowledge of an impending insolvency.

Contrary to the English law situation, the French legislator started to enact specific close-out netting legislation well in advance of the implementation of the FCD. It may be for this reason that the French close-out netting regime is not restricted in scope to the close-out netting provision being part of a financial collateral arrangement. The expansion of the recognition of close-out netting provisions was initially targeting specific financial contracts[53] and at these early stages recognition may be considered restricted. Thus, under the former triple close-out netting regime, there were no restrictions imposed in relation to securities lending other than that the operations had to be governed by a standard national or international master agreement, repo agreements had to be approved by the central bank Governor and under the third regime the operation of financial instruments had to be governed by the framework of rules of the relevant market association or by a master agreement respecting the general principles of national or international master agreements.[54] Also, it was initially only in the case

53 It has been seen in Chapter 5.3 that close-out netting regimes in France were enacted in 1987 in relation to the securities lending market, in 1993 to the futures market and in 1994 to the repos market.

54 See LE GUEN (2001) 43.

of the futures market that a close-out netting provision was enforceable notwithstanding the opening of insolvency proceedings. Standardisation of close-out netting as a regime was achieved in 2001 with the setting up of a single close-out netting regime which was conditional on one of the parties being an eligible financial markets party.[55] This was complemented by the introduction of global netting in 2001 which was considered as a major step in the protection of close-out netting at the time, though initially a connexity between the obligations had to be established by contractual provision, reminiscent of the requirements of set-off. Following the recognition of all modalities of termination, evaluation and set-off stipulated by contract in the 2005 law implementing the FCD,[56] it became important to clearly stipulate in the agreement all the details required to make the close-out netting effective, such as the way in which amounts in different currencies are to be evaluated and the contractual provisions linking the close-out netting of various products or of various netting arrangements in order to enable the global netting to take place. Thus, it can be acknowledged that the FCD had an important role in reinforcing the party autonomy role in the French close-out netting regime. However, on account of the need for the contract to stipulate certain details, it became the practice for French counterparties to resort to national or international master agreements in place for a particular financial product which could be relied upon to satisfy this requirement.[57] As a result, although in its current form, article L.211-36-1 of the Financial Code gives a full role to party autonomy which is equivalent to the 'in accordance with its terms' standard, it would appear that in practice French counterparties still operate under the old regime where recourse was required to be had to the standard master agreements.

Contrary to the gradual liberalisation of close-out netting under French law, the protection of the contractual rights of close-out and netting under section 560 of the Bankruptcy Code may be considered to have been fully liberalised from the start. Typical of all the US safe harbours, the enforceability of close-out netting goes beyond contractual arrangements and includes the protection of rights 'whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.' Thus, US law protects close-out netting both if it results from a written contract as well as from a business practice. This may appear similar to French law which recognises the modalities of termination, evaluation and set-off which *may* derive from an agreement or master agreement, thus giving rise to the interpretation that these may arise from sources other than an agreement or master agreement but do not exclude the latter.

55 It was extended to include public entities under the regime of former article L.431-7 of the Financial Code.

56 In fact, it has been seen in Chapter 5.3 that the major influence of the FCD upon French law has been in relation to the increase in the type of financial obligations falling within the scope of the close-out netting regime.

57 JURISCLASSEUR (2013) Fasc. 2050, paras 79 & 83.

But whilst French law gives full effect to the modalities as stipulated by contract, the protection given under section 560 of the Bankruptcy Code is that contractual rights 'shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.' Although this protection is significant, it cannot be said to be equivalent to the standard of granting protection to a close-out netting provision 'in accordance with its terms' as is more clearly stipulated in section 403 of FDICIA. Section 403 of FDICIA has sought to codify the US close-out netting regime insofar as regards major dealers who enter into netting agreements. When recognising close-out netting provisions, section 403 of FDICIA provides for the enforceability of the netting of payment obligations under a netting contract '[n]otwithstanding any other provision of State or Federal law', other than stipulated provisions relating to resolution measures, and 'in accordance with, and subject to the conditions of, the terms of any applicable netting contract (except as provided in section 561(b)(2) of title 11)', the latter relating to certain obligations entered into in relation to commodity contracts governed by the Commodity Exchange Act. It is therefore now clearly the case that US law also protects a close-out netting provision 'in accordance with its terms', at least for those dealer agreements which fall within the scope of application of section 403 of FDICIA.

Mandatory Set-off Rules

A major distinction in the set-off law of the three selected jurisdictions is that set-off is subject to the voluntary act of the creditor under French and US laws, whilst it is mandatory and self-executing under English law. French law changed from a mandatory to a voluntary set-off system following amendments to the Civil Code in 2016. This distinction in the nature of set-off is expected to significantly influence the close-out netting regimes of these jurisdictions.

The mandatory and self-executing nature of insolvency set-off under English law implies that it will replace a close-out netting provision in circumstances where the requirements for the application of insolvency set-off are fulfilled. This position has been confirmed in the FCAR consultation document where it is stated that the former rule 4.90 will continue to apply to financial collateral arrangements.[58] Notwithstanding this general assertion, two important points should be noted in relation to the role of insolvency set-off. First, it has been seen in Chapter 4.3 that although the FCAR regulations 12(4) & 14 disapply certain provisions on insolvency set-off rules, this does not mean that the rest of the provisions on insolvency set-off are applicable. This seems to be the established interpretation even though it would seem rather odd to exclude only certain provisions when

58 HM TREASURY 2003 FCAR Consultation Document, para. 5.9.

all should be excluded. Second, it is difficult to understand when insolvency set-off may replace close-out netting given that one important constitutive element of close-out netting, namely the termination element, is missing from the constitution of insolvency set-off. Basing themselves on the experience of the administration of Lehman Brothers International, Yeowart *et al.* state that set-off may replace close-out netting if before contractual close-out netting takes effect, notice is given by the administrators of the defaulting parties of their intention to make a distribution or an order is made for the winding-up of the defaulting party. In these circumstances, insolvency set-off could occur before the non-defaulting party has given notice of early termination. The non-defaulting party will then find its transactions valued in accordance with insolvency set-off rules.[59] One solution suggested by Gullifer to avoid replacement is to ensure that the close-out netting provision does not operate by way of set-off but that the contracts are terminated and replaced with a new obligation to pay the net amount.[60] Gullifer refers, *inter alia*, to paragraph 5.9 of the FCAR consultation document cited above to support her argument. As a counterargument, however, one may raise three points. First, any reference to set-off as a modality to determine a single amount is to contractual set-off and not insolvency set-off. If the close-out netting provision is effective, the contractual set-off may be freely used to determine a single amount without fear that it is replaced by insolvency set-off. Second, it has been seen at the beginning of this research that whilst some types of transactions are better served by a set-off clause for executing the third step of close-out netting, others are more adapted to the determination of a single payment amount using the novation modality. Hence, it may be difficult to take the novation modality as a definite way of establishing a single payment amount. Third, insolvency set-off is self-executing and, it is understood, depends on the applicable circumstances and not on contractual arrangements. It is therefore argued that it should not matter that the close-out netting provision does not refer to set-off as a modality to determine a single payment amount since insolvency set-off will anyway apply if relevant requirements are fulfilled. It is rather an issue of timing and of whether the conditions for insolvency set-off to apply have been fulfilled prior to the exercise of the termination phase of close-out netting.

Under French law, on the other hand, set-off law does not appear to have any implications on the manner in which the contractual modalities of termination, valuation and set-off under article L.211-36-1 of the Financial Code may apply, provided all details necessary for their effectiveness have

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59 YEOWART *et al.* (2016) 233. Firth recommends that close-out netting should be drafted in a way as to fulfil the requirements of insolvency set-off so that the agreement can still be upheld in the event of a liquidation or a distribution by an administration. FIRTH (2013) para 5.068. This, however, would deny to the close-out netting provision all the contractual enhancements it is meant to achieve.

60 GULLIFER (2017) 386.

been stipulated by contract or other type of arrangement. No requirements are imposed in relation to the actual or constructive knowledge of the impending insolvency as is the case under English law and neither does the law impose any element of reasonableness in the drafting of these modalities. Given that there is no notion of insolvency set-off under French law and that set-off of any kind should be invoked by the creditor, if the same creditor may also benefit from a close-out netting provision, then depending on the circumstances and fulfilment of applicable requirements, the creditor may choose to either invoke set-off or exercise its rights under the close-out netting provision. This is the case since set-off, like close-out netting, is a voluntary act subject to the will of the creditor invoking it.

Similar to the situation under French law, ordinary set-off has to be invoked under US law and, being a voluntary act, the creditor decides which netting mechanism to resort to, provided the requirements or contractual conditions of the selected mechanism have been fulfilled. Under the US safe harbours, contractual rights are given full protection of the law provided the right falls within the scope of application of these safe harbours. The question in this case, which also arises under the other laws, is to define those circumstances where both concepts can be applied alternatively given that one of the constitutive elements of close-out netting is the termination or acceleration of outstanding obligations. It is arguable that either there is the need to terminate and then only close-out netting applies, given that section 560 of the Bankruptcy Code and section 403 of FDICIA refer to netting as related to close-out positions, or ordinary set-off can take place since there is no need to terminate. In the latter case, it is then difficult to conceive how close-out netting may be exercised. It would therefore seem that under US law circumstances might dictate whether it is possible to use one concept instead of the other and this is especially the case in administration whether the bankruptcy trustee may decide to exercise ordinary set-off before the creditor has the opportunity to operate the close-out netting provision.

Mandatory Insolvency Law Rules

The carve-outs benefitting close-out netting provisions are typically related to the disapplication of insolvency rules in line with the general understanding that it is upon insolvency that the enforcement of a close-out netting provision is mostly problematic given the mandatory nature of most national insolvency principles. On the other hand, as declared in the UNIDROIT Principles, such carve-out should not extend to cases where a close-out netting provision is entered into with the knowledge of an impending insolvency proceeding or in order to affect the ranking of categories of claims or to avoid a transaction as a fraud to creditors.[61] The

61 See UNIDROIT 2013 Close-out Netting Principles, Principle 7(2).

purpose of this part of the comparative analysis is to examine whether for the three selected jurisdictions the carve-out is all-encompassing, subject to the application of the safeguards suggested by the UNIDROIT Principles, or whether any insolvency rules continue to restrict the enforcement of close-out netting provisions.

In terms of English law, although regulations 8 and 10 of the FCAR disapply a number of insolvency law provisions in relation to financial collateral arrangements and close-out netting provisions falling within the scope of the FCAR, the disapplication is incomplete and a number of provisions of the Insolvency Act 1986 still apply. Most of these provisions signify an element of fraudulent intent on behalf of the solvent party and thus are in accordance with the UNIDROIT Principles cited above. According to Yeowart *et al.*, the FCAR 'leaves unaffected the general rules of national insolvency law in relation to the avoidance of transactions entered into during a prescribed period', which is typically two years prior to the commencement of insolvency or reorganisation procedures. Thus, according to these authors, it is possible, depending on circumstances, for a transaction to be challenged under the Insolvency Act 1986 for reasons that it was made at an undervalue under section 238, is a preference under section 239, is exceptionally a contract which should be rescinded by the court under section 186 or is a transaction defrauding creditors under section 423. These authors confirm that in each of these cases, there are certain requirements that must be met such as, for instance, in relation to preference there must be an intent to prefer the relevant creditor.[62] Firth raises the question whether the close-out netting provision itself, which is intended to improve each party's position in case of insolvency, can ever survive the test of the preference rules. Firth argues that since at the time of entering into the agreement none of the parties is yet a creditor or debtor of the other given that no transactions have yet been entered into, the entering into the close-out netting agreement in these circumstances cannot be said to constitute a preference for any of the parties.[63]

French law provides full protection under article L.211-40 of the Financial Code to article L.211-36-1 of the Financial Code from the provisions of book VI of the Commercial Code dealing with insolvency and from equivalent judicial or amicable procedures instituted under foreign laws. Gaudemet states that the general view in French doctrine is that although there should not be obstacles to the enforceability of a close-out netting provision on account of article L.211-36-1 of the Financial Code, given the systemic impact of these provisions an express exclusion provides the necessary comfort and legal certainty.[64] This derogation implies that a close-out netting provision is not affected by the stay which applies upon

62 YEOWART *et al.* (2016) 99.
63 FIRTH (2013) para 5.056.
64 GAUDEMET (2010) para 517.

the opening of a judicial reorganisation, safeguard or amicable proceeding as well as from the powers of the administrator to demand the execution of current contracts in terms of article L.622-13 of the Commercial Code as well as from the cherry-picking powers of the administrator. It also makes a close-out netting provision unchallengeable under the provisions relating to suspect periods under articles L.632-1, L.632-2, L.621-107 and L.621-108 of the Commercial Code. According to Terret, these derogations would seem to give the enforcement of close-out netting provisions the nature of a public order rule.[65] Roussille, however, cautions that since these are derogations from a number of important public rules of the law of collective procedures and the principles of the general equality of creditors, they must be narrowly construed.[66] Although this statement is in accordance with interpretation rules, it has to be noted that the wording of article L.211-40 of the Financial Code is construed in sufficiently wide and emphatic terms (‘*ne font pas obstacle*’) as to overcome any doubt of interpretation in favour of upholding the enforcement of a close-out netting provision in the light of any conflict with insolvency rules regulated by book VI of the Commercial Code.

Under US law, the derogation in favour of close-out netting in relation to insolvency law is stipulated in both sections 560 of the Bankruptcy Code and 405 of FDICIA. Section 560 of the Bankruptcy Code provides that the exercise of contractual rights ‘shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceedings under this title’, thus limiting the derogation to proceedings under the Bankruptcy Code. By way of practical application of this derogation, Roe states that the main derogations would regard the following: first, relevant counterparties can immediately enforce their claims at the beginning of the bankruptcy and are not impeded by the stay. Second, relevant counterparties do not need to return ‘eve-of-bankruptcy’ payments on old debts nor forfeit seized preferential collateral. Third, they have broader offset and netting rights that allow them to escape handing over money they owe to the debtor. Fourth, they are exempt from most fraudulent conveyance liability. Fifth, they can choose whether or not to terminate contracts under *ipso facto* clauses. Sixth, they need not suffer the debtor’s typical bankruptcy option to assume or reject the underlying contract.[67] In line with the UNIDROIT Principles, these derogations exclude any action taken with actual intent to hinder or defraud other creditors.[68] A similar exemption is provided by section 405 of FDICIA which provides that:

65 TERRET (2005) 53.
66 ROUSSILLE (2001) 315.
67 ROE (2011) 547. In this respect see also ROE & ADAMS (2015) 378; SCHWARCZ & SHARON (2014) 1718; LUBBEN (2009) 65.
68 See section 546(g) of the Bankruptcy Code.

'No stay, injunction, avoidance, moratorium, or similar proceeding or order, whether issued or granted by a court, administrative agency, or otherwise shall limit or delay the application of otherwise enforceable netting contracts in accordance with sections 4403 and 4404 of this title.'

This provision appears to be more comprehensive than section 560 of the Bankruptcy Code which only protects contractual rights from the provisions of the Bankruptcy Code. On the other hand, it has been seen that section 403 of FDICIA is more limited in personal scope than section 560 since it applies where both parties are major dealers. This or similar situations may have led to the statement made by Schwarcz and Sharon that 'exemptions sometimes lacked coherence, with rights available to counterparties differing from one financial product to another without clear economic rationale.'[69]

Following this comparative analysis, it can be said that whilst all three jurisdictions ensure a high level of protection for close-out netting provisions, the manner in which this is achieved differs between the three jurisdictions. English law does so on the basis of the implementation of the FCD, having formerly based the enforcement of close-out netting provisions on the flexible but mandatory rules of insolvency set-off. As a consequence, the recognition of close-out netting provisions under English law is based on the premise that the close-out netting provision forms part of a financial collateral arrangement. French law operated a specialised close-out netting regime before the implementation of the FCD. Recognition of close-out netting provisions under the old regime was, however, somewhat curtailed by the need to fulfil the requirements of industry bylaws, obtain authority permission or be based on standard national or international agreements in place for the respective financial product market. The regime was further liberalised following the implementation of the FCD, although the French legislator chose not to restrict its scope of application to financial collateral arrangements given that the former regime was not restricted in this way. Close-out netting rights under US law benefitted from the expanding protection given to contractual rights under the safe harbours and the wide scope of application of section 560 of the Bankruptcy Code and seemed to have benefitted from a liberal protection of party autonomy from inception, which was later strengthened by the enactment of section 403 of FDICIA.

In relation to the effect of set-off law on the recognition given to close-out netting provisions, English law operates a self-executing, mandatory insolvency set-off regime so that the latter displaces close-out netting when the conditions for insolvency set-off concur. Under French and US laws set-off has to be invoked in order to apply and hence it would seem that the creditor in these jurisdictions has a choice whether to invoke set-off or close-out netting rights. Under the three jurisdictions the faculty to terminate contracts is only available in close-out netting and if termination or acceleration is necessary, then the determination of a single amount through

69 SCHWARCZ & SHARON (2014) 1731.

ordinary set-off may be unfeasible. It seems that the most likely case where set-off may replace close-out netting arises where notice has been served on the creditors following the issue of a winding-up or administration order and the insolvency practitioner is able to invoke set-off through powers given by the law before the creditor has been able to give notice of early termination. In this case, it does not matter whether the set-off system is mandatory or not, but it is a matter of timing of the exercise of close-out netting rights.

In relation to the effect of insolvency law, whilst the English and US regimes allow for some form of insolvency law restrictions to apply, these mostly relate to fraudulent actions that are taken by the creditor and may be considered to conform to the type of fraudulent exceptions advocated by the UNIDROIT Principles considered above. It was also seen that US law grants different levels of protection to party autonomy, depending on the applicable regime. No restrictions seem to specifically apply to the French regime which recognises any modality of termination, valuation and set-off, although it is presumed that the maxim *fraus omnia corrumpit* could be made to apply. On the other hand, the specific derogations under French and US laws from their respective insolvency regimes have raised questions whether this implies that other non-insolvency regimes will continue to apply or whether the declaration that contractual modalities of close-out netting provisions will be upheld is sufficient to overcome any restrictions arising under these non-insolvency regimes.

7.3 Fulfilment of State Insolvency Goals

This last part of the comparative analysis will consider whether the recognition given to close-out netting provisions is meant to serve declared or implied State insolvency goals. This will be achieved in the first part by analysing whether a strategic decision was taken by the legislator, or where applicable, by the courts, to link the special treatment given to close-out netting to the attainment of a public policy. The second part of this comparative analysis will focus on the effect of resolution regimes on close-out netting in order to establish any convergence or standardisation in the type of restrictions imposed on the exercise of close-out netting rights and what was the drive for this convergence.

7.3.1 Congruence with State Insolvency Goals

Whilst historical events may have shaped much of today's national insolvency law, the evolution of public policies and approaches continue to influence its development and its impact on other branches of national law. From a historical perspective, the handling of and the attitude towards the insolvent debtor have varied in the three selected jurisdictions. Early English insolvency law was characterised by punitive measures against the debtor and it was only in the early eighteenth century that rehabilitation started to be recognised when a 1705 statute relieved traders of liability for existing debts, even though seizure of person or property was still possible.[70] Although the Enterprise Act of 2002 heralded the rescue culture, it has been stated that the 'present English rescue procedures might be portrayed as giving strong priority to the protection of creditor interests and limited priority to rescue […].'[71] The foundation of French insolvency law under the Commercial Code of 1807 was also based on the punishment of trader debtors, although this initial regime already started to be relaxed under the Act of 28 May of 1838.[72] French law is traditionally considered hard on creditors as they did not have a say in most insolvency decisions, the main reason being that the law is directed towards securing jobs by keeping troubled firms alive. The situation changed significantly with the introduction of the preservation procedure in 2005 which gave creditors a say in the approval of a rescue plan through creditors' committees for businesses above a certain threshold. In the US, Chapter 11 of the US Bankruptcy Code is described as 'strongly oriented to the avoidance of the social costs of liquidation and the retention of the corporate operation as a going concern' and the process is 'an instrument for debtor relief, not a remedy for creditors'.[73] Preservation of the company reflects the US concern to encourage investment in entrepreneurial ventures. These different approaches are the result of different value judgements made by the legislators towards the failing debtor and the protection of the creditor. This comparative analysis will serve, together with the analysis on the influence of insolvency law on the recognition of close-out netting provisions made in part 7.2.2 of this chapter, to provide replies in the Preliminary Conclusions on the second sub-question of the Introduction.

English Law

Rather unique circumstances surround the advent of the close-out netting regime under English law. Whilst in the other two selected jurisdictions the legislator created the close-out netting concept on the basis of a combination of existing concepts, the common understanding of English practitioners prior to the enactment of the FCAR was that close-out netting already worked under the mandatory, but flexible, insolvency set-off regime. This approach would indicate that limited consideration has been given to the contractual enhancement features of close-out netting and there seems to have been little understanding of its constitutive features, in particular of the termination feature which cannot be achieved on the basis of insolvency set-off. It has been seen that the implementation of the close-out netting

70 FINCH & MILMAN (2017) 8.
71 *Ibid.* 278.
72 Philippe Théry, 'The Evolution of Insolvency Law in France', in RINGE (2009) 2.
73 *Ibid.*

rules in the FCAR in 2003 was also considered unnecessary on the understanding that there were no formalities or other obstacles to the enforceability of close-out netting because of its assimilation with insolvency set-off. As a result of all this, it may be difficult to gauge the moment in time when a policy decision was taken, if at all, by the English legislator which may help to understand the rationale for the special treatment, other than to conclude that according to the English legislator close-out could already operate within the confines of insolvency law and its implementation in the FCAR was merely necessary to fulfil the EU obligation to transpose the FCD.

Indeed, a number of features of the close-out netting protection are congruent with the notion of 'references' typically allowed under English law. It has been seen in Chapter 4.4.1 that the protection given to close-out netting under the FCAR falls within the ambit of protection afforded to pre-contractual entitlements under English law, so long as the conditions of regulation 12(2) on actual or constructive knowledge of the pending insolvency do not materialise. It has also been seen that although a number of writers argue that the recognition given to close-out netting rights goes against the notion of *pari passu* which underlies the English insolvency system, it has been counterargued that the preference given to holders of close-out netting rights is one manifestation of formal equality in insolvency law which is determined by pre-insolvency law. According to this interpretation, what cannot be contracted out of is the whole collective system for the winding-up of insolvent estates but it is possible for the law to recognise a priority standing for a particular class of creditors.

However, without specific legislative recognition there remained much uncertainty about the applicability of the contractual enhancements of close-out netting. For instance, prior to the enactment of the FCAR the multilateral arrangement for the settlement of payments in the *British Eagle* case was considered as a means of 'contracting out' of the provisions of section 302 of the Companies Act 1948 for the payment of unsecured debt *pari passu*. On the other hand, English law may be considered willing to accommodate contractual innovations. Thus, some reliance could be placed on the English law principle that a contractual device should not be regarded as offensive if it is intended to operate in the same way outside and inside insolvency as it is not a device designed to improve the position of one party by reason of the insolvency of another, even though this argument was not accepted by the majority opinion in *British Eagle* in relation to the multilateral payment scheme. It is also to be noted that in the *BCCI (No 2)* case the court was ready to use imaginative judicial reasoning by finding a personal liability on the part of a director when guaranteeing the debts of the debtor company since this was perceived to lead to a just result. It would appear that where a commercially justifiable reason exists for a clause and there is no deliberate attempt to evade the insolvency laws, the English courts are prepared to give favourable consideration to such clause. These and other equitable principles, together with the strong pre-contractual protection culture, may have provided sufficient comfort to the market that close-out netting worked without the need to resort to *ad hoc* close-out netting law.

This conviction of the workability of close-out netting under English law is reflected in the way in which the FCD has been implemented through the FCAR. Contrary to the situation under French and US laws, the English legislator did not consider it necessary to extend the scope of application for the recognition of close-out netting provisions beyond the confines of financial collateral arrangements. On the other hand, the legislator did not hesitate to widen its personal scope to include arrangements concluded between two corporates on the assumption that this would be in accordance with English law overall objectives.[74] The widening of the personal scope in this way results in protection being given to close-out netting provisions which goes beyond the purpose of operating sound risk management practices as advocated by the Recital (14) of the FCD since the personal scope has been arguably set to fit the wider financial collateral regime served by the FCAR. Even the declaration made in the FCAR consultation document that the flexible approach taken to implement the FCD is intended to promote London as a global financial market[75] is presumably made in relation to the use of financial collateral arrangements rather than specifically to the recognition of close-out netting provisions. It appears that no specific goal has therefore been set for the way in which close-out netting considered on its own has been implemented. Given the close affinity with the traditional goal of enhancing creditors' rights evidenced in particular by the general principle on the respect for the pre-insolvency contractual entitlements, the recognition given to the contractual enhancements can easily fall within the scope of this goal. This is coupled with the understanding that close-out netting under English law is heavily impacted by insolvency set-off as a notion and which as a right is available to any party, whether financial, corporate or individual.

French Law

Whilst there may be congruence for the preferential treatment given to netting creditors with State insolvency goals under English law, the same cannot be said for French law. French law does not consider pre-insolvency contractual entitlements favourably. Following the introduction of the judicial restructuring procedure by the law of 13 July 1967, secured and

74 HM TREASURY 2003 FCAR Consultation Document, para 2.2.

75 *Ibid.* para 1.12: '[…] We have sought to promote further flexibility in the use of financial collateral arrangements in order to assist the competitive position of London as an international financial market.'

unsecured creditors were treated without distinction.[76] With the introduction of the safeguard procedure in 2005 and of the accelerated financial safeguard procedure in 2014 priority was again given to the restructuring of the business over the protection of creditor interests. Also, the application of French insolvency law principles is rather distinctive in comparison with the other two jurisdictions. Thus, although French law operates a 'freeze' on creditor action, this only regards creditors whose claims originate prior to the commencement of collective proceedings. Claims arising after the commencement are paid without delay if they are properly incurred for the restructuring of the failing business. This state of affairs whereby claims arising after the commencement of insolvency proceedings may be settled immediately may help explain the erosion of the *pari passu* principle under French law and the marked absence of requirements tied to the actual or constructive knowledge of the impending insolvency.

Against this background of priority given to the rescue of the failing business, a stark contrast exists with the preference given to netting creditors. Arguably the main reason for this turnaround advanced by both doctrine and politicians in France is that the protection to netting creditors is based on economic reasons and is required to enhance the competitiveness of the French financial market. It has been seen in Chapter 5.4.2 that on the occasion of the commemoration of the bicentenary of the Commercial Code in 2007, former President Sarkozy declared that commercial justice should be at the service of the dynamism of the French economy and should be inspired by the US Chapter 11 model in order to encourage entrepreneurs to develop initiative and the taste for risk. Synvet acknowledges that the aim for the derogations was initially to strengthen legal certainty for operators, to limit counterparty risk and to avoid chain defaults that could lead to the commencement of collective proceedings against one of them. Synvet considers that it is difficult to justify the protection of close-out netting on the grounds of systemic risk when its protection is extended to agreements concluded by any corporate or physical person with an eligible party.[77] He concludes by commenting that '[t]he truth is that it is a matter of giving French banks a competitive advantage in international competition, even at the price of sacrificing the interest promoted by the law of businesses in difficulty.'[78] On the other hand, Gaudemet notes that under the

76 This happened because secured creditors were required to submit their claims for verification and this was used by the courts as a pretext for applying the stay of individual actions to them, as well as the prohibition of enforcement proceedings until their claims were admitted. Cass Ass plén, 13 February 1976, Bulletin civil Ass plén, no 3, p 4. See Hervé Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', in RINGE (2009) 161.

77 It should be noted, however, that close-out netting provisions concluded between an eligible party and a very large corporate may still entail risk of systemic proportions.

78 Hervé Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', in RINGE (2009) 163 & 179.

cover of measures against systemic risk, French law has imported English concepts which are traditionally favourable to creditors of a debtor in difficulty, bringing into question whether the law of insolvency proceedings can remain based on the objective of the debtor's reorganisation and the principle of equality among creditors.[79]

The theory advocated in this research is that possibly there are two rationales for the way in which close-out netting developed in France. The first regards the period of time preceding the transposition of the FCD when the French close-out netting regime was developed to serve as a loss indemnification mechanism for the financial markets. This is evidenced especially by the initial focused attention to the requirements of the individual markets and by the condition imposed by the various regimes that close-out netting provisions should be based either on industry bylaws or on national or international master agreements in place for that particular market. Even with the unification of these separate regimes into one, the law still imposed the requirement of compliance with the regulations or master agreements in place for the industry. The various changes to the close-out netting regime, in particular the establishment of a single regime and the extension to global netting both in 2001 generated intensive debate on how far to extend the liberalisation of the close-out netting regime in order to protect the market from losses. Although the contractual modalities of termination, valuation and set-off were consistently protected from the application of insolvency law, prior to the implementation of the FCD this was the case provided the close-out netting provision was consistent with the regulations and standard agreements of the market. Hence, the basis of the protection was self-regulation by the market.

Upon implementation of the FCD, the close-out netting regime became more liberal. Although the law still speaks in terms of the modalities of termination, valuation and set-off when referring to close-out netting, a break with the past seems to have taken place upon implementation of the FCD in 2005 where reliance was no longer placed on existing standard agreements or industry bylaws. The Report to the President on the law implementing the FCD[80] reflects the intention of the legislator to widen the scope of the regime and to delete existing restrictions under French law. Of course, this position was taken in relation to the whole financial collateral regime under the FCD, but certain changes made by the French legislator indicate that specific decisions were also taken in respect of the close-out netting regime, such as the option made in relation to the personal and material scope of application and the decision not to restrict the close-out netting provision to the confines of a collateral financial arrangement . This

79 GAUDEMET (2010) paras 564 & 567.

80 *Rapport au Président de la République relative à l'ordonnance no 2005-171 du 24 février 2005 simplifiant les procedures de constitution et de realisation des contrats de garantie finacière*, NOR: ECOX0400308P.

widened French regime may go beyond the scope of the FCD of putting in place sound risk management practices and is arguably explained by the desire of the legislator to be as competitive and flexible as other jurisdictions in the field of the financial markets.

US Law

The US bankruptcy regime, similar to the French regime, is not generally speaking favourable to the creditor. The rationale of US bankruptcy law is based on the notion of the discharge for the debtor with the ultimate goal being to encourage risk-taking in order to foster entrepreneurship. It has been seen in Chapter 6.4.1 that the US insolvency law principles protect the going-concern value of the insolvent debtor by imposing a stay on individual creditor action, the annulment of fraudulent conveyances of the debtor's assets and a ban on *ipso facto* clauses that make the filing of a petition for bankruptcy an event of default. US law is not based on the recognition of pre-insolvency entitlements and most creditor claims are also subject to the debtor's or bankruptcy trustee's power to assume or reject contracts, even though this is subject to court approval. This allows the debtor to maximise the value of its own business.

The legislative treatment of the safe harbours is contrary to the scope of US bankruptcy law since it promotes the individual pursuit of claims and the seizing of collateral up to the eve of bankruptcy without the need to observe any suspect period. This could easily frustrate going-concern value and debtor rehabilitation since power is taken away from the debtor or bankruptcy trustee and given to the netting creditor to pursue its individual claims. Officially, the need for the safe harbours has been based on the avoidance of systemic risk. The US legislator has deemed that financial contracts should not be subject to the delays of the Bankruptcy Code since they must be actively traded on the market and are subject to the risks of fluctuating values inherent in the financial markets. A number of critics have argued that following the enactment of the first safe harbour in relation to the commodities and forward contracts, the further extensions of this initial safe harbour are to be considered as path dependent. In such circumstances, it is difficult to trace whether the development of the enforceability of close-out netting is the result of a conscious decision taken by the legislator to pursue a defined public policy in the light of the rationale of US bankruptcy law.

Schwarcz, a proponent of the path dependency view, notes that:

> 'The derivatives safe harbor, at least in part, is an outcome of decades of sustained industry pressure on Congress to exempt the derivatives market from the reach of bankruptcy law, with each exemption serving as an historical justification for subsequent broader exemptions'.

Schwarcz notes that whilst the first safe harbour of 1978 was very narrow in scope and was based on one case cited before Congress, this served as a precedent for further expansions of the safe harbours.[81] Edwards and Morrison, critics of the risk systemic theory, observe that the fear of derivatives-induced systemic risk is warranted only in the case of an insolvency of a major financial market participant holding a massive derivatives portfolio.[82] The safe harbour exemptions, however, operate independently of the size of the counterparty or its portfolio. In addition, they apply not only to financial firms but to any firm that holds a derivative.

It is important to bear in mind that the US legislator was not specifically targeting the protection of close-out netting when establishing the first safe harbours, rather the US legislator was protecting the exercise of contractual rights in relation to financial contracts. This makes it more difficult to understand the goal aimed to be achieved by the derogations granted in favour of close-out netting. Indeed, the protection to both close-out and netting as contractual rights first took place in the 1990s by the enactment of sections 560 and 561 of the Bankruptcy Code in relation to swap and master agreements, and this came at a time when the lobbyist movement led by ISDA was putting pressure on legislators to ensure that the effectiveness of close-out netting arrangements in relation to the newly-emerging derivatives market 'would not be prevented by the automatic stay'.[83] The establishment of a legally sound close-out netting regime in the US would have been an excellent trendsetter for other legislators to follow suit.

It is difficult to establish a single State insolvency goal that was meant to be achieved for the special treatment given in the safe harbours under US law since there are various levels of protection afforded by law. Thus, although the US legislator has stipulated that the safe harbours were required to mitigate against systemic risk, this may be seen to apply in certain instances but not in others. Following from this, the path dependency theory may be perceived to apply in certain instances but not in others. Thus, the first time that close-out netting was protected in 1990 through section 560 of the Bankruptcy Code, the US legislator might have been acting under the impression that the swap safe harbour as drafted was required to prevent systemic risk but the wide terms in which it is construed and the fact that it applies to any participant to a swap agreement, itself widely defined, does not make the systemic risk goal very credible. On the other hand, it appears that some assessment of systemic risk was made in the definitions of financial participant under the BAPCPA of 2005 and of financial institution under Regulation EE issued by the Federal Reserve under section 402 of FDICIA since both these terms impose high thresholds of business that must be transacted by the counterparty to benefit from the safe harbours to which they refer. As a result, there apply in parallel

81 SCHWARCZ (2015) 703.
82 EDWARDS & MORRISON (2005) 98.
83 SCHWARCZ & SHARON (2014) 1730.

two different regimes. Those safe harbours which fall squarely within the parameters of section 560 of the Bankruptcy Code have a wide scope of application which is difficult to justify under the system risk goal since they apply to any party to a swap agreement. This can be either explained as informational blindness in terms of the path dependence theory or it reflects the entrepreneurship spirit of the US legislator which encourages risk-taking, although the latter assumption is unlikely since section 560 of the Bankruptcy Code was enacted for the declared purposes of averting risk. On the other hand, counterparties to transactions not falling under the swap agreement definition of section 560 of the Bankruptcy Code and who qualify as either financial participants under BAPCPA or financial institutions under FDICIA face a size or threshold test which may be assumed to serve the systemic risk goal sought to be achieved by the US safe harbours. It is difficult to identify a one-size-fits-all goal for the Bankruptcy Code and the FDICIA regimes and it would have been of great benefit had the legislator amalgamated them into one coherent regime.

Three Different State Insolvency Goals

The comparative analysis of the State insolvency goals set by the legislators of the three selected jurisdictions for the special treatment given to close-out netting indicates that there is no convergence of public policy approaches in this respect. Some common aspects in the historical development of the respective insolvency laws of these jurisdictions have been identified. Thus, whilst both the English and French regimes historically sought to punish the insolvent trader, the US legislator has since early times been prone to discharge the insolvent trader in order to encourage entrepreneurship through risk-taking. Currently, all three jurisdictions have their own restructuring regimes which target the rehabilitation of the debtor or its business. However, fundamental differences exist in the way in which the regimes treat creditors' rights, with the English legislator being a staunch defender of creditors' pre-insolvency rights whilst the other two jurisdictions take a more cautious approach in upholding such rights, with US law giving an active role to the failing debtor to manage its business through the DIP function. The comparative analysis has revealed that when assessing the treatment to be given to close-out netting rights certain value judgements have been clearly based on, or have been influenced by, these national historical developments, but in other instances global developments may have exerted more influence on the legislator.

It is questionable whether the English legislator would have enacted a specific close-out netting law had it not been for the need to transpose the FCD. The transposition itself does not appear to be based on any specific goal, other than to transpose the whole financial collateral regime of the FCD in a way to retain the flexibility already existing under the English regime. Indeed, the conviction that close-out netting already worked under the existing insolvency set-off regime and the fact that the legislator did not feel the need to enact a specific close-out netting regime prior to the FCD make it hard to discern any specific goal which the English legislator intended to achieve with the close-out netting regime it has put in place. The view taken in this research is that since in the end the favourable treatment may be considered congruent with the pre-insolvency contractual entitlements approach already existing under English law and which are given priority ranking similar to real rights, there was no need for a special State insolvency goal to justify the special treatment given to close-out netting.

The French legislator, on the other hand, already had in place a specific close-out netting regime well ahead of the transposition of the FCD. Considering its unfavourable policy on pre-insolvency contractual rights, this early close-out netting regime took on the nature of a loss indemnification mechanism which was initially market-specific, relied exclusively on market rules and established market agreements, and only gradually was made available in situations of insolvency. At the time of the implementation of the FCD the French legislator was open to consider the importation of foreign concepts and to adopt a more liberal approach which would render the French economy more competitive. Thus, for the first time the transposition of the close-out netting provisions gave full recognition to party autonomy and no longer referred to industry bylaws or practices which is typically necessary to establish loss indemnification amounts. Also, the fact that the personal scope has been widened to include agreements on financial instruments concluded between parties one of whom may be a corporate or physical person indicates that the goal may now go beyond that of providing loss indemnification to financial market participants. These changes, coupled with the willingness of the French legislator to take on board other foreign concepts, may serve to indicate that the goal for the basis of this treatment was the openness of the French legislator to innovation in order to enhance the competitiveness of the French markets.

Finally, the US regime has consistently declared the protection against systemic risk as being the goal set for the safe harbours. However, the wide scope of application of its main safe harbour, namely section 560 of the Bankruptcy Code makes it difficult to understand how this can be an overarching goal for the close-out netting protection given under the safe harbours. Whilst the path dependency theory has been put forward by a number of US proponents for the approach taken by the US legislator in enacting the safe harbours, it has been observed that there are instances under BAPCPA and FDICIA where consideration has been given to matters such as the size and volume of business of a counterparty which indicate more clearly the pursuit of the systemic risk goal. The end result is that US law does not in practice follow a single approach in its close-out netting regime so that whilst in the cases of BAPCPA and FDICIA the pursuit of the articulated systemic risk goal is plausible in the circumstances mentioned, in other instances the wide scope of application is perhaps best explained by the external pressure placed on the US legislator to ensure the protection of the derivatives industry.

7.3.2 Effect of Resolution Measures

The different State insolvency goals of the three selected jurisdictions may have served to shape the close-out netting regimes currently in place in each of these jurisdictions. The recent financial crisis has brought a shift in thinking about systemic risk and the importance of financial stability. This resulted in the enactment of special resolution regimes mainly for the banking sector which has restricted the exercise of close-out netting rights. The issue to be considered in this part is whether the general pursuit of the financial stability goal has brought an element of convergence in the type of restrictions imposed on the exercise of party autonomy in close-out netting through the resolution regimes of the three selected jurisdictions and the observations made will be used to provide replies in the Preliminary Conclusions to the third sub-question of the Introduction. It is expected that greater similarities will be found between the English and French regimes since both implement the EU's BRRD.[84]

Whilst all three resolution regimes cover banks or important financial institutions in their personal scope, not all regimes make it mandatory to take into account the systemic importance of the institution prior to triggering the resolution regime. English law introduced a banking resolution regime in the Banking Act of 2009, which was later revised to implement the BRRD. The Banking Act regulates the resolution, insolvency and administration of banks and certain investment firms so that these are no longer subject to the provisions of the normal insolvency regime. The French legislator first adopted a resolution law[85] triggered by the FSB Key Attributes and based on a proposal of the draft BRRD so that it already incorporated most of the restrictions affecting close-out netting which are contained in today's BRRD, albeit not with all the details and safeguards provided under the current French banking resolution law.[86] Under French law a bank or investment firm may only be put in resolution if a number of considerations materialise which indicate the systemic importance of that institution. Thus, a determination has to be made in each case to decide whether a particular bank or investment firm is of systemic importance and should therefore be subject to the resolution regime. US law operates different resolution regimes under the FDIA and OLA regimes. The former covers the resolution and liquidation of all credit institutions and replaces the application of the Bankruptcy Code insofar as concerns failing credit institutions. The latter applies to non-bank SIFIs which have been determined as systemically

84 It will be recalled that banks and investment banks falling within the scope of the Single Supervisory Mechanism are governed by the Single Resolution Mechanism Regulation referred to in Chapter 3.2.4.

85 Law No. 2013-672 of 26 July 2013.

86 Ordinance no. 2015-1024 of 20 August 2015, codified in articles L.613-34 *et seq.* of the Financial Code.

important under the OLA regime so that the Bankruptcy Code, including the safe harbours, are only replaced if a determination is made about the systemic importance of the non-bank financial institution. As a result, given that the two regimes may serve to replace the provisions of the Bankruptcy Code, they both reproduce the safeguards for close-out netting provisions envisaged in the safe harbours, save for the restrictions indicated below.

Ban on Ipso Facto Clauses

A common concern of all regimes, influenced by the recommendations made in the FSB Key Attributes, is to stop or delay the ability of counterparties to trigger the exercise of the close-out netting provision based solely on the occurrence of a resolution-related event. Thus, all regimes impose a ban or a temporary suspension on the exercise of *ipso facto* clauses triggered by the exercise of one or more resolution measures. Section 48Z of the Banking Act 2009 prohibits resorting to *ipso facto* clauses triggered by the exercise of resolution measures.[87] This provision is not meant to prevent the operation of default clauses which are based on a failure to perform the substantive obligations under the contract or events not directly linked to the application of a crisis prevention measure or crisis management measure. French law, on the other hand, contains a general rule in article L.613-50-3 of the Financial Code that articles L.211-36-1 to L.211-38 of the Financial Code[88] shall not hinder the application of resolution measures. This is a general rule which seems to set a blanket prohibition on the application of, *inter alia*, close-out netting provisions when this could disturb the effectiveness of resolution measures. Construed as it is in vague terms, this may result in wide implications and uncertainty of application. In addition to this general prohibition, French law still contains a number of provisions on the suspension of the exercise of termination rights and set-off rights, amongst other rights, in order to allow specific resolution measures to be exercised, provided always that other essential obligations of the contract continue to be performed. In this respect, article L.613-50-4 of the Financial Code imposes the suspension in relation to the exercise of resolution measures generally, whilst articles L.613-52 and L.613-56-3, III do the same in relation to the issue of transfer orders and to the exercise of the bail-in tool respectively. The FDIA and OLA regimes reinforce the statutory ban on *ipso facto* clauses triggered solely on the grounds of the financial condition of the institution and the appointment of a receiver or conservator, as applicable, and in the former case this ban applies until 5:00 p.m. on the business day

87 Also, in terms of this provision, the Bank of England may provide in any mandatory reduction instrument, share transfer instrument, property transfer instrument or resolution instrument that a default event provision should be disapplied in a particular case even if the general rule does not apply.

88 These provisions transpose the FCD.

following the date of appointment of the receiver.[89] Therefore, contrary to the English and French regimes which impose a ban on *ipso facto* clauses so long as substantive obligations continue to be performed, the FDIA and OLA regimes impose a ban in the case of the appointment of a conservator whose task is to preserve the failing business and a temporary suspension in case of the appointment of a receiver who will ultimately liquidate the business.

Transfer Orders

In addition to the general restriction imposed on *ipso facto* clauses, two other common rules specifically targeting close-out netting rights regard the suspension of the exercise of termination rights in relation to the transfer of close-out netting contracts and the prohibition of the partial transfer of close-out netting contracts. Thus, in relation to the first, in all three jurisdictions the resolution regimes provide for the temporary suspension of the exercise of close-out netting rights to allow the resolution authority to transfer all obligations under a contract.[90] Since the English and French regimes are based on the BRRD, almost identical conditions and safeguards are imposed in these jurisdictions to protect, to the extent possible, the close-out netting mechanism. Thus, under these two regimes the resolution authority is empowered to suspend termination rights, defined to include also acceleration, close-out, set-off and netting rights, of any party to a qualifying contract where all obligations under the contract continue to be performed up till midnight of the business day following the day when the instrument provided for the suspension is published and provided the resolution authority does not give notice that the transfer will not take place. The BRRD safeguards apply in the sense that the termination right may be exercised after the expiration of the suspension period if following the transfer of the contract there subsists an event of default which may trigger the termination of the contract. It may be exercised before if the resolution college informs it that the contract will not be transferred or that it will not be subject to recapitalisation measures. Less safeguards appear to be afforded under US law where both FDIA and OLA prohibit the counterparty from terminating, liquidating or netting a qualified financial contract after

89 12 U.S.C. §§1821(e)(10)(B)(i) & (ii), & 5390(c)(10)(B). Under the OLA regime, the restriction applies only in relation to the appointment of a receiver.

90 See Section 70C, Banking Act 2009, article L.613-56-5 of the French Financial Code & 12 U.S.C. §§1821(e)(10)(A)(B) & (ii), & 5390(c)(10)(B). During this period, the obligations of the parties are also suspended.

they receive notice that the contract has been transferred to a third party.[91] It is assumed that these rights may be exercised once the transfer is complete and an event of default occurs in relation to the transferee counterparty. The situation under current US law is similar to that obtaining under English and French law prior to the implementation of the BRRD when a number of safeguards, as mentioned above, were added to protect either the close-out netting mechanism or the effect of the resolution measure on systemic risk.

Second, all three jurisdictions protect against partial transfer orders which serves to ensure that property included under a counterparty's netting arrangement cannot be 'split up' through the exercise of a property partial transfer, which also includes protection of any collateral securing the transactions.[92] Whilst all regimes converge on this point, special reference should be made to the English Banking Act (Restriction of Partial Property Transfers) Order 2009 whereby in case of a contravention of this partial transfer prohibition, articles 10 of the 2009 Order provides that the partial property transfer order is void and article 11 provides that the partial property transfer does not affect the exercise of the right to set off or net. The former provision is intended to provide an administrative remedy in relation to a contravention of article 3 of the 2019 Order.[93]

Bail-in

One important key difference between on the one hand the US regime and on the other the English and French regimes which are based on the BRRD, relates to the bail-in tool. OLA and FDIA do not include an explicit bail-in tool because all liabilities are subject to impairment and bail-in to cover losses after closure.[94] For this reason there are no explicit safeguards for the treatment of netting creditors in the case of the exercise of a bail-in tool. There are also significant differences in the exercise of this tool under the English and French regimes.[95] Both regimes provide for the general BRRD rule that liabilities relating to derivatives and financial contracts must be converted into a net debt, claim or obligation before they can be bailed in.

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91 Citing a number of references, Kounadis states that:

> 'the suspension regime could fulfil its risk mitigation purpose (or be the least disruptive for the smooth functioning of netting) as long as the resolution actions in relation to close-out suspension are subject to certain – clearly spelled out – requirements. It is thus imperative that ability to impose a brief delay on the exercise of early termination and netting rights is subject to certain conditions ensuring appropriate safeguards for close-out netting.'

KOUNADIS (2015) 234. The US regime does not seem to satisfy this expectation.

92 See regulation 3, Banking Act (Restriction of Partial Property Transfers Order 2009, article L.613-57-1 of the French Financial Code & 12 U.S.C. §§1821(e)(9) & (10), & 5390(c)(9)(A).

93 See ISDA 2019 Allen & Overy, 111.

94 For a more detailed explanation of the differences between the exercise of the bail-in tool in the EU and the US, see KRIMMINGER & NIETO (2015) 5.

95 See section 48B, Banking Act 2009 & article 4, Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014, & article L.613-55-6 of the French Financial Code.

However, beyond this general rule there are significant differences between the two regimes. Thus, under English law the valuation of the net amount may be done either in accordance with the relevant arrangement specified in the contract or by special bail-in provision which empowers the Bank of England to make an estimate of the net amount.[96] On the other hand, article L.613-55-6 of the French Financial Code provides that the respective obligations owed between the parties must be settled on a net basis as foreseen by the netting arrangements so that the bail-in provision is only exercised on the net amount as originally agreed by the parties. This is contrary to other valuations foreseen in the Financial Code where the normal rule is for this to be calculated by an independent expert.[97] Another important difference is that under English law the special bail-in provision does not foresee the close-out of netting arrangements but solely the determination of a net amount. French law, on the other hand, empowers the resolution college under article L.613-55-6, repeated in article L.613-56-3, of the Financial Code to itself terminate the financial contract to be able to exercise the bail-in provision. Thus, whilst under English law there is continuity of contracts when exercising the bail-in tool, French law has taken the BRRD option to terminate the contracts prior to exercising this tool.

A general safeguard set by the BRRD is that creditors are not treated worse than they would have been in insolvency.[98] This principle has been implemented by the English legislator in Section 60B of the Banking Act 2009 in relation to the bail-in provision. The French legislator, however, has implemented a wider notion of 'no-creditor-worse-off' principle under article L.613-57 of the Financial Code since this principle is generally applicable not only in relation to bail-in but also to transfer orders. In both situations, the redress is by way of compensation and not by reinforcing the close-out netting provision. Although not limited to a particular resolution measure, a limited form of redress is also available under the OLA regime to compensate creditors if they would have received better treatment had their situation been addressed under the Chapter 7 liquidation of the Bankruptcy Code.[99]

Extent of Convergence

Given the global nature of the recent financial crisis and the ensuing declarations on resolution measures issued by international bodies such as the FSB, it is to be expected that similar measures were taken by legisla-

96 This may not be consistent with Article 49 of the BRRD which requires the valuation to be done in accordance with the provisions of the netting agreement.

97 See article L.613-47 of the Financial Code. Under the former 2013 resolution regime, the valuation of obligations under derivatives and financial contracts was also based on expert valuation.

98 See Article 34(1)(g) of the BRRD.

99 See 12 U.S.C. §5390(a)(7)(B).

tors to address these resolution concerns. In broad terms, an element of convergence exists in the three types of restrictions imposed on close-out netting identified above, namely the ban or suspension of *ipso facto* clauses, suspension related to transfer orders and the exercise of bail-in, but with substantial variations in the details. English law has imposed a ban on such clauses but leaves open the possibility for the counterparty to trigger close-out netting if a substantive breach of the contract occurs. The French legislator has enacted specific provisions suspending the exercise of close-out netting rights in relation to the various resolution measures. The same safeguard exists that in case of substantive breach, the close-out netting provision again becomes enforceable. US law imposes a ban in case of conservatorship and a suspension in case of receivership but does not offer the same safeguard.

The highest level of convergence has been found to exist in relation to the issue of transfer orders. Two common features regard the imposition of a temporary suspension in order to allow for the effective transfer of contracts and a corresponding safeguard against partial transfers of obligations related to the same close-out netting arrangement. An interesting point is that prior to the BRRD, these rules would have been close to identical in all three jurisdictions. However, following the implementation of the BRRD, a number of safeguards were introduced in the English and French regimes in relation to the suspension which are not reflected in the US regimes.

Arguably the most defining restriction for all the three jurisdictions and the one which mostly sets the level of protection given to party autonomy is that relating to bail-in. Although a type of bail-in exists under US law which takes the form of an impairment of obligations due by the failing debtor, no specific protection for close-out netting exists. Notwithstanding that both implement the BRRD, there are two important differences between the English and French regimes. One difference is more technical and relates to the fact that under French law the contracts need to be terminated by the resolution authority whilst English law foresees the continuity of contracts. More significant is the fact that it is mandatory under French law for the resolution authority to resort to the contractual valuation modality when calculating the net amount of the obligations subjected to the bail-in tool. English law, on the other hand, provides a choice and empowers the resolution authority to estimate a net amount using the special bail-in provision.

All in all, it can be said that the restrictions imposed by the three regimes do have broad similarities, but there are also significant differences which imply different levels of protection to close-out netting provisions. Notwithstanding the general similarity, it is in the details that the greatest contrasts are to be found. For instance, even if it appears that there is a common approach for close-out netting provisions not to affect the exercise of resolution measures, the differences in treatment between imposing a ban or a suspension and whether this is accompanied by a safeguard as aforesaid leaves a great impact on the protection of interests which a close-out netting provision seeks to achieve.

7.4 Preliminary Conclusions

A number of conclusions may be drawn from the comparative analysis made in this chapter. First, it has been demonstrated that close-out netting is not simply an economic outcome but is a legal concept regulated on its own right under the law of the three jurisdictions. This was not always the case under English and US laws given that under English law close-out netting initially received recognition under the regime of insolvency set-off whilst under US law it gradually received protection as a contractual right under the safe harbour regime. These issues were gradually addressed through the enactment of specific legislation with the result that today the concept of close-out netting is a comparable one and may be considered as one and the same concept across the three regimes.

Second, the comparative analysis has made it possible to provide replies to the three sub-questions raised in the Introduction. These replies, in turn, should be indicative of the characteristics of the legal systems of the three selected jurisdictions which have shaped the type of recognition given to close-out netting provisions and which will be the principal focus of Chapter 8. Each of the replies will be tackled below.

First Sub-question

The influence of set-off rules on the development of close-out netting is mostly present under English law. Close-out netting initially had to satisfy insolvency set-off requirements for its enforceability. Arguably for this reason, its recognition under the FCAR may have not been given the attention it deserves by the legislator with the result that today protection of close-out netting provisions under the FCAR is restricted to those provisions which form part of a financial collateral arrangement. On the other hand, the close association with insolvency set-off may have also influenced the legislator to opt for a wide personal scope to include arrangements concluded between two corporates. In view of this situation, it is arguable that the protection against systemic risk was not even contemplated at the time.

Although close-out netting under French law was built on the existing concepts of termination and set-off, the numerous occasions in which the French legislator has amended and finetuned the close-out netting regime indicates that from an early stage close-out netting developed as a separate stand-alone concept providing compensation against financial loss which was not influenced by set-off requirements. The concept also operates with flexibility which is evidenced, for instance, by the way in which the French legislator applied the FCD opt-out on the scope of application which sees a wider material scope if both parties are eligible entities and a narrower material scope if only one of the parties is an eligible person. The fact that French law extends protection to cases where one of the parties is a corporate or physical person would tend to indicate that the scope behind the French national close-out netting regime goes beyond the protection against systemic risk. The unhindered development of close-out netting was possible due to a number of reasons such as the non-public policy nature of legal set-off, the existence of principles such as the payment of post-insolvency creditors' claims and the general acceptance of exceptions from the *pari passu* treatment of claims.

It is difficult to consider close-out netting under US law as a contractual enhancement of ordinary set-off. Close-out netting appears to have developed as a separate notion under the Bankruptcy Code safe harbours. Indeed, the US legislator created the specific notion of offset to replace set-off under the safe harbours which, although leading to the same economic outcome as ordinary set-off, benefits from the same derogations as close-out netting and is not subject to the restrictions of ordinary set-off. The protection of contractual freedom under the safe harbours was recognised from the start and was based on protection from any stay, avoidance or court and administrative orders issued under the Bankruptcy Code.

Second Sub-question

The recognition given to close-out netting provisions under the English FCAR 'in accordance with their terms' is congruent with the favourable treatment under English law of pre-insolvency contractual entitlements. However, one significant limitation is that close-out netting provisions are recognised under this standard only if they fall within the scope of the FCAR, with one of the requirements being that the close-out netting provision forms part, or is related to, a financial collateral arrangement. Close-out netting provisions not falling within the scope of the FCAR continue to be regulated by insolvency set-off rules. Close-out netting under English law (whether falling within the scope of the FCAR or otherwise) is subject to principles relating to the absence of preferential action and of actual or constructive knowledge of insolvency. Although not lacking in controversial debate, the imposition of the observance of these principles may have served to justify the preferential treatment given to close-out netting provisions under the *pari passu* principle. It has been argued in this chapter that on account of its congruence with pre-insolvency contractual entitlements and its compatibility with a number of English law axioms, the recognition of close-out netting under the FCAR does not seem to have been based on any particular State insolvency goal other than the general goal of the preservation of pre-insolvency contractual rights.

The French legislator initially based the recognition of close-out netting clauses on the regulatory and contractual standards set by the markets. It was only upon transposition of the FCD that full contractual freedom in formulating close-out netting provisions was recognised. This transition has led to the proposition made in this research that whilst initially changes to the close-out netting regime were motivated by the State goal of establishing a loss indemnification mechanism for the financial market, the harmonisation of various aspects of the European single market, including that of financial collateral arrangements under the FCD, was considered as an opportunity to focus on the competitiveness of the French market. As a result, French law provides a liberal close-out netting regime that nowadays does not appear to be influenced by insolvency law, given that there is a full and unconditional exemption for close-out netting from the provisions of insolvency law.

The protection of contractual freedom of close-out netting parties under the US safe harbours was from the start based on protection from any stay, avoidance or court and administrative orders issued under the Bankruptcy Code. A step further was achieved by FDICIA which protected close-out netting provisions concluded by market dealers under the 'in accordance with its terms' standard. The protection granted under FDICIA therefore goes beyond that of the Bankruptcy Code. Under both FDICIA and the safe harbours, however, no protection is given from fraudulent acts. Similar to other previously existing safe harbours, the protection given to close-out netting provisions in particular in relation to section 560 of the Bankruptcy Code was based on the goal of protecting against systemic risk. However, the wide definition of swap agreement and the fact that section 560 covered any party to a swap agreement led to the argument that it is difficult to justify the special treatment given under section 560 on this basis. This has led to the debates on the path dependence theory in terms of which each new expansion of the safe harbours was used to justify further expansions. The conclusion reached in this research is that during the period of the enactment of section 560 of the Bankruptcy Code lobbying pressure may have influenced the US legislator to stipulate wide protection for close-out netting in relation to swap agreements to ensure adequate coverage of the newly-emerging derivatives market. However, it has been noted that later expansions relating to BAPCPA and FDICIA, which imposed thresholds to the definitions of financial participant and financial institution, respectively, indicate the taking into account of systemic risk considerations in the formulation of the US close-out netting regime.

Third Sub-question

A significant level of convergence has been noted in the resolution regimes of the three selected jurisdictions insofar as concerns the type of restrictions imposed on the exercise of close-out netting rights, especially in relation to the imposition of a temporary stay on the exercise of close-out netting rights. It would thus appear that the global movement, taking the form of declarations by international regulatory bodies and the enactment of regional legal acts such as the EU's BRRD, have influenced this convergence. On account of the implementation of the BRRD, more similarities have resulted in the English and French regimes. However, certain disparities in the detail of these restrictions imposed on the exercise of close-out netting rights have been also noted.

Under English law, restrictions were introduced first in a temporary Banking Act of 2008. At this stage and following the enactment of the original version of the permanent Banking Act of 2009, not many safeguards were included, but the situation was remedied with the implementation of the BRRD. Compared with the other two jurisdictions, English law is not the most favourable in relation to the protection of close-out netting provisions under the resolution regime and this may be due to the fact that certain restrictions applied under the pre-BRRD regime continue to exist under the current regime.

It has been observed that although the French banking resolution regime has imposed some restrictions on the exercise of close-out netting rights in pursuit of the principle of financial stability on account of the implementation of the BRRD, the French legislator took the options which are most favourable to the netting creditor and those which safeguard the terms of the close-out netting provision. In comparison with the other two jurisdictions and consistent with the liberal way in which close-out netting has been protected post-FCD implementation, the French resolution regime may still be considered as having adopted the most liberal and favourable approach in its safeguards to close-out netting provisions.

It is arguably in the US resolution regimes under FDIA and OLA that one sees a more pronounced restrictive approach in the exercise of close-out netting rights when compared with the other two selected jurisdictions. Thus, to provide one instance, the bail-in tool, although existing under US law, does not benefit from the same protections given to the close-out netting provision as under the English and French regimes. When considered together, these US resolution regimes are wider in scope than the applicable resolution regimes of the other two jurisdictions. They also give significant power to the resolution authorities without applying corresponding safeguards to the creditors, including those benefitting from close-out netting arrangements.

Whilst a more detailed elaboration of the influence of the legal systems of the three selected jurisdictions on the recognition of close-out netting provisions will be made in the next chapter, the comparative analysis of this chapter has served to delineate the characteristics of the national close-out netting regimes of the three selected jurisdictions which may not have been possible if each were considered on its own. Although it is typically assumed that close-out netting provisions, especially in master agreements, are best concluded under common law jurisdictions such as English law and New York law, with US federal law regulating the insolvency aspects of it, this assumption may not always be correct since it has emerged that French law, a traditional civil law system, has arguably a more liberal close-out netting regime than the other two jurisdictions.[100]

100 The favourable treatment by French law of creditor rights has been recently confirmed by the choice of French and Irish laws to govern the ISDA master agreement in an attempt to mitigate Brexit risks. See in this respect, DOWNE (2019) 660.

8 The Influence of the Legal Systems on the Recognition of Close-out Netting Provisions

8.1 Influences on the Development of National Close-out Netting Regimes

The comparative analysis of the laws of the three selected jurisdictions has portrayed both similarities and variances in the way close-out netting has been influenced (or not) by the rules of three particular regimes, namely the set-off, insolvency and resolution regimes. On the basis of the outcome of this comparative analysis, in this final chapter a reply will be given to the main research question on whether the legal systems of England, France and the US have influenced the recognition given to insolvency close-out netting provisions as developed under the *lex mercatoria*. It will be recalled that for the purposes of this research the term *lex mercatoria* has been defined in the Introduction to refer to the influence and standardisation brought about by the declarations of international regulatory bodies, the rules of financial market associations and their standard master agreements which is considered as soft law, capable of exerting moral suasion on national legislators. In the case of England and France, further influence has been exerted by the binding provisions of applicable EU netting law. In addition, a brief description of the historical origins of the civil and common law traditions to which the selected regimes pertain has also been made in the Introduction. The choice to analyse the laws of England, France and the US was justified on the basis that the comparative study of the recognition of close-out netting is more effectively addressed by comparing the close-out netting regimes of jurisdictions that pertain to different legal systems.[1]

It is expected that the philosophy and doctrine of a legal system exerts a significant influence on the development of new law. Micheler is of the view that although the law changes and adapts to new demands and circumstances, change is affected by adapting existing legal concepts, rather than by introducing new legal concepts, in order to avoid legal uncertainty. She considers that even changes related to convergence occur only on the functional level since legal systems continue to use the legal technique most suitable under national law to achieve the desired outcomes.[2] This implies

1 It has been seen in the Introduction that English law follows the common law tradition, French law is a civil law country with its origins in the Napoleonic Code whilst the US has 'evolved a hybrid system of common and legislated laws that is broadly pro-debtor with significant pro-creditor exceptions.' See BERGMAN *et al.* (2004) 6.

2 MICHELER (2006) 50.

that the doctrine and philosophy of the legal systems will perpetuate themselves in new legal developments and this could, as a result, limit the techniques available to a national legal system to respond to the pressure exercised by globalisation.[3]

It is interesting to note the remarks made by Dalhuisen and Goode on the congruence or acceptance of the *lex mercatoria* in common and civil law jurisdictions. Dalhuisen remarks that the *lex mercatoria* in international dealings partakes of the characteristics of common law and this is apparent in the greater reliance on practices, custom and party autonomy, in its operating from case to case, its sensitivity to the facts and in supporting new business structures.[4] On the other hand, Goode notes that the *laissez-faire* approach of the *lex mercatoria* is much less acceptable to civil law jurisdictions where a number of rules particularly in property law are incompatible with modern methods of dealing and finance.[5] Both authors agree that modern states wanting to benefit from globalisation are likely to adjust their regulatory regimes to the *lex mercatoria* in order to create a more level playing field for market players. It may therefore be the case that also modern civil law jurisdictions are amenable to adapt their laws as a response to the needs of international commerce and finance to ensure that their legal systems remain competitive.

It is proposed to deal with the main research question in the following way. First, the original and current role played by set-off in the three selected jurisdictions will be analysed. Set-off achieves the same economic result as close-out netting and may shed light on whether precepts which influenced the development of set-off have also played a role in the recognition of close-out netting. Second, it will be considered whether the development of close-out netting has occurred in a way which rendered this concept congruent with the rationale and principles of national insolvency law or whether it developed in a way which transcends the precepts of insolvency law and follows different state goals. Third, the EU's FCD sets standards on the recognition of close-out netting provisions which were implemented by the EU Member States. It will be considered whether in the case of English and French laws these standards may have influenced a deviation from the traditional approach taken by the legal systems to which they pertain or whether the implementation of the FCD was carried out predominantly under the influence of these legal systems. Finally, the financial crisis of 2007-2009 brought about a series of recommendations from international regulatory bodies which was followed by the adoption of resolution regimes globally to address failing banks. These resolution regimes have

3 Dalhuisen considers that the inclination for legislators to lean on the comfort of the established framework is an inhibiting factor in the development of a *lex mercatoria*, and this despite the fact that national frameworks do not cope well with international transactions. DALHUISEN (2015) 59.

4 DALHUISEN (2019), Volume 1, 29.

5 GOODE (2005) 541.

restricted the exercise of close-out netting rights. For EU Member States, these limitations have been set by the BRRD. In this final part it will be examined whether there is a common trend in the limitation of close-out netting rights which may have been influenced by these international developments or whether the influence of the legal systems continues to dominate even in the implementation of bank resolution regimes.

8.2 The Role and Development of Set-off Within the Legal Systems

The relationship between set-off and close-out netting has already been discussed in the national chapters principally from two perspectives, namely whether close-out netting may be considered as a contractual enhancement of the concept of set-off and what is the role, if any, still played by set-off under the close-out netting mechanism. The contractual enhancement aspect was further considered in the comparative analysis of Chapter 7.2.1 where it was generally concluded that in relation to the three selected jurisdictions close-out netting can be considered as an independent concept which does not, strictly speaking, depend on the observance of set-off rules for its enforceability. This part will briefly consider the role fulfilled by legal or insolvency set-off within the legal system of the three selected jurisdictions. Whilst the historical origins of set-off under Roman law and its introduction in the three selected jurisdictions were discussed in Chapter 1.2.1, this part will identify its original and current function, and delineate any fairness, moral or efficiency considerations which influenced its development. Given the close affinity of the concepts of set-off and close-out netting and the similar economic outcome that they achieve, this review is to serve as one of the bases in this chapter for considering whether the same or similar influence of the legal systems which has served to shape set-off can still be traced in the development of close-out netting.

English Law

It has been seen in Chapter 1.2.1 that set-off was originally met with resistance in England, mostly due to the formalistic pleading procedure at the time (which did not allow for collateral issues to be taken into consideration) but was gradually considered favourably on account of its equitable treatment features. In fact, the first historical role given to set-off by statute in 1705[6] was that of a defence for the alleviation of the hardship of bankrupt prisoners. Later, the 1729 statue[7] established a general right to set-off under common law intended to avoid the imprisonment of debtors who could not pay their debt when they had a counterclaim arising out of the same

6 Act of 4 Anne (1705).

7 Act for the Relief of Debtors with respect to the Imprisonment of their Persons (1729) 2 Geo. II.

transaction. The Debtors Relief Amendment Act of 1735[8] confirmed and extended the 1729 statute to cover mutual debts deemed by law to be of a different nature. According to Pichonnaz, the aim of these statutes was not only to avoid multiple actions in justice but also to render common law more in conformity with the equity required by natural justice.[9] McCracken considers that the notions of justice and fairness behind the statutory recognition of set-off in insolvency in the 1705 statute to be narrow insofar it was confined to the interests of debtor and creditor, making no reference to the interests of third parties.[10] Of the same view is McCoid who attributes the thinking at the time to the situation that the bankruptcy trustee was considered as successor to the debtor's interests in property, rather than as a representative of creditors.[11]

Under current English law the role of insolvency set-off is no longer to avoid multiplicity of actions but rather to ensure material justice between the parties and has therefore taken on a more substantive role. Its rules have become mandatory and parties may not derogate therefrom. The debate on its moral justification continues. In *Forster v Wilson*[12] the court held that the policy behind the mandatory nature of insolvency set-off is to rectify the perceived injustice of a debtor of an insolvent who is also the insolvent's creditor having to pay the full amount of their liability to the insolvent, whilst receiving only a reduced dividend on its cross-claim. Peck *et al.* criticise this traditional justification for insolvency set-off and contrast the situation with that of equitable set-off outside insolvency, which is available only where the cross-claims are so closely connected that it would be manifestly unjust to allow one of them to be liquidated without taking the other into account. They conclude that to the extent that insolvency set-off goes beyond this requirement, it cannot be justified by reference to fairness.[13] To these arguments Derham adds that the right of set-off operates irrespective of whether the set-off was actually relied on by the parties when entering into the transaction or whether it was acquired coincidentally by a third party through assignment. In the latter case, he considers that the justification arguments brought in favour of insolvency set-off may not carry the same weight.[14] Various arguments may be brought in relation to the repercussions of insolvency set-off on the application of the *pari passu* principle, mainly that it allows the solvent party to collect payment ahead of other creditors to the extent of the set-off and thus fewer assets will be left for distribution among general unsecured creditors. All in all, however, the

8 Act for the Relief of Debtors with respect to the Imprisonment of their Persons (1735) 8 Geo. II.
9 PICHONNAZ (2001) 574.
10 McCRACKEN (2010) 51.
11 McCOID (1989) 21.
12 [1843] 12 M&W 191.
13 PECK *et al.* (2011) 5.
14 DERHAM (2010) 245.

general view under English doctrine is arguably that insolvency set-off is an equitable concept which is compatible with the protection of pre-insolvency entitlements typically protected in common law jurisdictions.

French Law

It has been seen in Chapter 1.2 that the development of set-off under French law has been influenced by the rules on *compensatio* found in Justinian's Code. Writing at the time preceding the drafting of the Napoleonic Code, Pothier considered set-off as a form of payment or extinguishment of debts and which therefore had to partake of the strict requirements of payment. Thus, the two debts had to be due between the same persons and in the same right, be in the same coin, fully due and liquidated. Pothier concluded that set-off was automatic on the basis of the interpretation of the words '*ipso iure*' in Justinian's Code.[15] Pothier's teaching formed the basis of the Napoleonic Code's articles on set-off. Pichonnaz notes that whilst the Napoleonic Code was very clear that set-off is automatic and is effective even against the will of the parties, it was not long before French authors would argue that set-off had to be pleaded in court as a matter of practicality and the existence of the debt had to be proved in order for the judge to take it into account. Being a means of extinguishment of debts, it could also be raised at any stage of the proceedings and if not raised the creditor was considered to have renounced to its right for compensation.[16] Contrary to English law therefore, set-off under French law was from inception regarded as a substantive matter, rather than a procedural tool, since it was deemed effective from the moment when set-off requirements had been met.

Notwithstanding the changes to the set-off regime of 2016, the new articles 1347 to 1348 of the Civil Code replacing the former articles 1289 to 1299 still place set-off under the heading of Extinguishment of Obligations so that set-off is still considered as a simplified means of payment. In addition to the statutory recognition of three types of set-off, namely legal, judicial and contractual, the current French Civil Code has imposed under article 1347 the requirement that set-off is invoked. This new requirement has generated discussion on its interpretation, as seen in Chapter 5.2.1, but typical of civil law jurisdictions this has not led to a debate on fairness considerations. This arguably reflects the civil law idea that the law is what the legislator says it is and value considerations are not given paramount importance. On the other hand, whilst French law does not distinguish between the types of set-off in an insolvency situation so that each type may be rendered applicable, it does provide in article L.622-7, I of the Commer-

15 Pothier, *Traité des obligations* §§ 624, 626, in 2 Oeuvres 1 (Bugnet ed. 1861), cited by TIGAR (1965) 246.

16 PICHONNAZ (2001) 512.

cial Code that set-off of pre-insolvency claims is exempted from insolvency law observation periods only in respect of connected claims[17] and provided these have been declared in terms of article L.622-24 of the Commercial Code. In the reasoning of Peck *et al.* cited in the part dealing with English law, this solution appears to be more just in relation to the preference given to the set-off creditor than the notion of insolvency set-off under English law which gives the parties considerable flexibility, including the possibility of setting off a claim following an assignment so that claims being set-off are not necessarily connected, though they must be mutually owed. Similar to English law, payments of matured debts performed after the date on which a company becomes insolvent are voidable if the beneficiary had actual knowledge of the company's insolvency.[18]

Although set-off under French law retains the original purpose of a simplified means of payment, it is not easy to establish if its nature has changed with the new invocation requirement. In its origins, French set-off law of the Napoleonic Code of 1804 was based on the interpretation of Justinian's Code that set-off operated automatically (*ipso iure*), even against the knowledge of the parties. Later, in an 1880s law,[19] set-off was held not to be a matter of public policy and it could be renounced by the parties. This could be due, at least partly, to the fact that the function of set-off is that of a simplified means of payment and hence is not primarily linked to the fulfilment of an equitable purpose. In relation to judicial proceedings, a consistent line of doctrine developed stating that set-off has to be invoked to enable the judge to take cognisance of it. This notwithstanding the former article 1290 of the Civil Code providing that set-off takes place automatically, even against the will of the parties. A consequence of this doctrine is that the non-invocation of set-off was interpreted to imply that the creditor was renouncing its right of set-off. With the recent changes to the Civil Code, set-off must be invoked in order to be effective so that the renunciation element has been replaced by a suspensive condition to invoke the set-off which is then made effective retroactively from the date when all conditions for set-off have been fulfilled. Hence, what started as a procedural requirement that the creditor raises the plea of set-off in judicial proceedings, has now become a substantive mechanism dependent on the will of the parties. But in any case, set-off was, at least since the 1880s law, already dependent on the will of the parties, either because it could be renounced or, under current law, because it needs to be invoked.

17 See article L.622-7, I of the Commercial Code. It has been seen in Chapter 5.2.1 that the French courts have stated that claims are connected when they result from the same contract or when carried out pursuant to different contracts which constitute a single global business relationship agreement.

18 See article L.632-2 of the Commercial Code.

19 Req. 11 mai 1880.

US Law

Regulation of set-off in the US predates the English statutes since as early as 1645 the colony of Virginia and Maryland permitted the set-off or discounting of debts. Based on notions of fairness, all bankruptcy statutes beginning with the Bankruptcy Act of 1800[20] have provided for the set-off of mutual debts and credits. Similar to English law, under US law set-off began as an innovative pleading tool raised in defence to a claim in court and was based on natural justice considerations. With the advent of the liberal pleading rules embodied in the Federal Rules of Civil Procedure, much of the original purpose and procedural complexities of set-off disappeared. As a result, set-off now operates also outside of judicial proceedings and, although still subject to court intervention at times, has become a widely recognised area of substantive law.[21]

The US courts played a significant role in the development of set-off, particularly in the initial stages. It has been seen in Chapter 6.2.1 that the US courts were initially reluctant to allow set-off in reorganisation cases since this was deemed to go against the principle of a fair and proportionate distribution to creditors and advocated a case-by-case assessment of the situation intended to give the debtor or the trustee the opportunity to propose a reorganisation plan. By the time of the promulgation of the Bankruptcy Reform Act of 1987, the general approach taken by the courts was that set-off is a fair and equitable process to satisfy creditors' claims and, subject to some court intervention, is generally enforceable. Most courts now permit set-off absent 'compelling circumstances' and treat it essentially as a security interest, rather than as the equitable remedy of its origin.[22] The security justification became entrenched in the Bankruptcy Code of 1978 whereby section 506(a) declares that, similar to a claim secured by a lien, a claim subject to set-off under section 553 of the Bankruptcy Code is secured.

Under US law, set-off is primarily regulated by State law, which rules are pre-empted by the provisions of section 553(a) of the Bankruptcy Code upon the bankruptcy of the debtor. It is generally a voluntary act which requires invocation by the creditor and whose enforcement lies within the discretion of the bankruptcy court. Perhaps more than the other two jurisdictions, the intervention of the courts is typically resorted to under US law in case the basic requirements of set-off, in particular those relating to maturity and liquidity, cannot be met. As a general rule, the Bankruptcy Code still subjects the exercise of set-off to the general principles of the automatic stay, the prohibition of creditor preferences and the prohibition of fraudulent transfers. Hence, the principle of maximisation of the value of the bankrupt's estate is foremost in the mind of the legislator. However, certain inroads have been made into the strict application of these principles

20 The Bankruptcy Act of 1800, ch. 19, § 42, 2 Stat. 19, 33 (repealed 1803).
21 SEPINUCK (1988) 54.
22 SEPINUCK (1988) 57.

by the aforementioned section 553(a) of the Bankruptcy Code, giving rise to some exceptions which seek to allow the exercise of set-off where this was considered justified. Thus, in relation to the automatic stay, section 553 of the Bankruptcy Code protects the set-off of mutual debts that arose before the commencement of the bankruptcy proceedings, whilst court approval is required to implement a right of set-off in relation to claims that arise after the commencement of bankruptcy proceedings. This gives the opportunity to the court to appreciate whether set-off is merited in these circumstances. In relation to the prohibition of creditor preferences, the enforcement of set-off is generally restricted by the ninety-day observation period.[23] In relation to the prohibition of fraudulent transfers, if an obligation of the debtor is the result of a fraudulent transfer, the bankruptcy trustee, acting under powers granted to it by section 548 of the Bankruptcy Code, may avoid that obligation and so it would not be available for set off against any debts owed to the debtor. US law therefore permits few exceptions in favour of set-off from the application of US bankruptcy law principles.

Distinctive Tendencies of the Legal Systems

The above analysis has sought to give an overview of the scope and development of set-off in the three selected jurisdictions in order to trace tendencies of the applicable legal systems.

From its inception set-off under English law was a procedural mechanism intended to facilitate relations between parties and was based on equitable grounds but took into account principally the interests of the parties to the transaction, rather than the general body of unsecured creditors. The foundation on which set-off was built served to consolidate the role of set-off into a more substantive one and led to the creation of the notion of insolvency set-off which is mandatory and self-executing. It may be difficult to understand why the legislator chose to render the concept mandatory rather than provide a mechanism of 'self-help', especially since various authors have expressed views that set-off under English law operates also as a kind of security, which is typically voluntary in nature. Also, given the flexibility with which the concept operates without the need for court intervention and given that there is no strict connexity required for claims to be set off upon insolvency, it is difficult to reconcile this notion with its self-executing nature, its equitable foundation and the insolvency state goal of business rescue entrenched in the Enterprise Act of 2002. On the other hand, it is easy to categorise the rights derived from set-off as a type of pre-insolvency contractual entitlement under English law which constitutes a statutory exception to the *pari passu* principle and is evident of the pro-creditor tendency of the English insolvency set-off regime.

23 See Sections 553(a)(2)(3) & 553(b) of the Bankruptcy Code.

Typical of civil law countries in Western Europe, the origins of set-off under French law were heavily influenced by Roman law. Given Pothier's interpretation of the Justinian's rules of *compensatio*, set-off was rendered automatic under the Napoleonic Code. The nature given to set-off is thus the result of the technical interpretation of the words '*ipso iure*' used in the Justinian Code and nowhere does it appear to have been based on considerations of fairness and morality. Notwithstanding its automaticity, set-off could, since its early stages, be renounced by the parties and at law it was not considered to be a matter of public policy. This state of affairs may be explained by the fact that the role given to set-off under French law was a functional, rather than a moral, one. Set-off was in fact considered as one type of mechanism to extinguish debts (and hence was always a substantive matter), and the initial strict basic requirements which needed to be fulfilled and its automatic nature were deemed compatible with set-off being a means of payment. Set-off is today still considered as a simplified means of payment. Set-off was from the beginning a voluntary act, considering that the possibility to renounce to set-off has now been replaced by the need to invoke it. Once invoked, it produces retroactive effect from the moment when its basic requirements have been fulfilled. Due in large part to its nature as a means of payment, the French legislator did not deem it necessary to create the notion of insolvency set-off but instead the existing types of set-off continue to be regulated by the normal insolvency law principles, save where exceptions are permitted by law. The two principal exceptions are that pre-insolvency claims should be connected and post-insolvency claims will be set off if required for the purpose of the proceedings, subject to the discretion of the courts. It is difficult to make a categorical statement that the regulation of set-off under French law adopts a pro-debtor approach. In its fundamental aspects, it may be stated to be pro-debtor mainly for the reasons that it is not mandatory and self-executing, it does not benefit from a pre-insolvency entitlement privilege regime and it is subjected to the insolvency law principles, save where otherwise permitted. On the other hand, certain pro-creditor traits can also be detected, the main one possibly being that the exceptions from the application of the insolvency law principles apply to all three types of set-off recognised under French law, namely legal, judicial and contractual, which implies that as long as there is mutuality and connexity, contractual arrangements on set-off will be enforced upon insolvency. This renders the set-off regime under French law more advantageous than the English regime at least in one important aspect, namely that under contractual set-off it is even possible for parties to convert by agreement non-monetary obligations such as delivery obligations into monetary ones.

The beginnings of set-off under US law were similar to those of English law set-off. Thus, set-off developed as a defence and a pleading tool in court based on equity considerations and obtained a more substantive role once it became more widely established. It is also considered as a form of security. Notwithstanding these similarities with English set-off law, the US set-off regime is in doctrine considered to be pro-debtor with a few pro-creditor exceptions. Similar to the French regime, the US set-off regime is, depending on the applicable state law, a voluntary act and has to be invoked. There is greater reliance on court intervention than in the other two jurisdictions for the fulfilment of its basic requirements when these have not been fully met. Set-off continues to be regulated by the insolvency law principles of the Bankruptcy Code save for exceptions permitted by section 553 of the Code. Claims arising between the parties prior to the ninety days' period which are not considered as fraudulent conveyances are generally permitted to be set off upon bankruptcy, but other claims remain subject to the ninety-days' observation period rule and may require court intervention to be set off. Set-off under US law therefore partakes of the substantive nature of set-off under English law, needs to be invoked as under French law but its unique feature is the extent of court intervention still required to permit its enforceability upon insolvency. Overall, US insolvency set-off law may be considered as the most pro-debtor of the three selected jurisdictions.

8.3 Tracing the Link between Set-off, Close-out Netting and Legal Systems

A general assumption was made in Chapter 1.2 that close-out netting is typically based on national pre-existing legal concepts which have been combined, adapted and enhanced to serve the needs of the financial markets. This research has focused on the concept of set-off as forming the basis for the contractual enhancement aspects of close-out netting. Other concepts have also been mentioned as playing a role, albeit a more restricted one, such as the account current and novation. The common aspect of these concepts is the ability to reduce the exposures of the parties to one single amount. For this effect to be achieved, a number of basic requirements need to be fulfilled, such as the reciprocity of the amounts owed. It has been seen in relation to set-off that an element of flexibility may apply under national law in the fulfilment of these basic requirements. The general trend is for the contractual enhancement aspects of close-out netting to go beyond this flexibility allowed by national insolvency set-off law. In this part it will be analysed whether these contractual enhancements as they relate to party autonomy still follow the characteristics and tendencies of the legal systems to which they relate, namely those of England, France and the US. The influence of the legal systems on the development of close-out netting will take into account both the scope and development of close-out netting in the three selected jurisdictions, other general precepts and legal doctrine of the applicable legal system as well as its congruence with insolvency law and state insolvency goals.

8.3.1 English Law

In Chapter 4.2 two phases in the development of close-out netting under English law have been noted. Initially, close-out netting was given effect under the mandatory provisions of insolvency set-off as evidenced by the 1993 Guidance Notice on Netting of Counterparty Exposure issued by the Financial Law Panel. As a result, close-out netting provisions had to be drafted in a way which abided by insolvency set-off rules.[24] At a second stage, with the enactment of the FCAR in 2003 close-out netting provisions forming part of a financial collateral arrangement as defined by those Regulations were recognised under the standard 'in accordance with its terms' and it was no longer necessary to adhere to insolvency set-off rules for their validity. The FCAR regime implements the EU's FCD which is principally concerned with the harmonisation of financial collateral across the EU. It is on the basis of the FCAR that an analysis will be made of the influence exerted by the English legal system on the recognition given to close-out netting provisions.

8.3.1.1 Relationship with Set-off

Close-out netting provisions regulated by the FCAR have been given recognition without the necessity that these adhere to the mandatory insolvency set-off rules. This state of affairs raises two observations. First, notwithstanding that insolvency set-off replaces other forms of set-off including contractual set-off, it does not seem to replace insolvency close-out netting. This could result from the fact that English common law recognises the development of concepts under non-statutory sources, such as party autonomy, so that the rules on insolvency set-off affected only part of the concept of close-out netting. It also reflects the situation that insolvency set-off may only be exercised in respect of executed contracts and it does not, technically speaking, involve any termination of transactions, the overlap with close-out netting lies only in the third phase of netting so that it is not the whole concept which is subjected to the insolvency set-off rules as otherwise there is no possibility to exercise the termination and valuation phases according to the terms of close-out netting provisions.

Second, the question arises whether close-out netting which used to be, or still is, regulated by the rules on insolvency set-off also shares the same role and justification for its foundation. In this research, close-out netting has been considered as an independent concept separate from insolvency set-off but which, prior to the enactment of the FCAR, relied on the mandatory rules of insolvency set-off for its enforceability. Insolvency set-off developed out of the need to maintain fairness between the parties and is today considered a type of security to the parties for the discharge of

24 YEOWART *et al.* (2016) 228.

obligations, at least up to the lesser amount due. The fulfilment of its basic requirements is considerably flexible. Thus, for instance, whilst reciprocity of claims is an essential requirement, legal doctrine recognises that it may be satisfied through intra-group guarantees and third-party assignment of debts, which arrangements are not readily recognised under the other two selected jurisdictions, at least without court intervention. It cannot be said with certainty that prior to the FCAR close-out netting performed the same role and developed on the same equitable basis as set-off, although it shared the same legal basis. It has been seen earlier in this chapter that the main policy justification for set-off under English law is that mutual credit has been given by the parties on the basis of the understanding that these could be set off against each other, so that one credit serves as security for the other. Close-out netting was from inception a risk mitigation tool created by the financial market on the basis of party autonomy and, in the absence of *ad hoc* statutory recognition, relied on the flexible rules of insolvency set-off for its enforceability. Such a situation would probably not have been possible in a civil law country where contracts rely on statutory fiat for their validity, but it is arguably possible in a common law jurisdiction where external sources such as party autonomy may be taken into account for the operation of contractual arrangements as long as they do not breach mandatory law. The mandatory law in this case relates to insolvency set-off which operates with sufficient flexibility to permit the operation of most close-out netting provisions though not without an element of uncertainty as to the extent of their enforceability. For a significant period of time therefore the English financial market players were operating the concept of close-out netting with this uncertainty which may have led the Financial Law Panel to issue the Guidance Note on the Netting of Counterparty Exposure in 1993 and, to a limited extent, fulfil the task which should have been the legislator's, *i.e.* to provide certainty on the enforceability of close-out netting provisions at a time when the derivatives market was gaining importance and England did not have its own netting legislation. It is indeed surprising that the English legislator did not take the opportunity of providing more certainty by enacting netting legislation but waited until 2003, when the UK was obliged to transpose the provisions of the EU's FCD, to do so.

8.3.1.2 Scope of Application

The adoption of the FCAR in 2003 solved a number of uncertainties concerning the enforcement of close-out netting provisions. It will be recalled that since the main scope of the FCAR is to transpose the provisions of the FCD, it is primarily a law regulating the harmonisation of financial collateral arrangements so that the provisions on the recognition of close-out netting provisions operate within this context. For this reason, certain options taken by the legislator, such as the scope of application of the Regulations, were taken foremost with the regulation of financial collateral arrangements in mind. One such instance is that the protection given to close-out netting provisions relates only to those provisions which form part of a financial collateral arrangement. Although this is sufficiently widely framed and should cover master agreements typically entered into by the financial community, it has created the situation whereby those close-out netting provisions not covered by the FCAR continue to be subject to the uncertainty created by the mandatory rules of insolvency set-off, as was the case for all close-out netting provisions prior to the enactment of the FCAR.

It is doubtful whether this was the intention of the legislator, *i.e.* to create two different close-out netting regimes, or whether this was the inadvertent consequence of the faithful implementation of the FCD. The view expressed in this research is that the existence of two regimes is the consequence of the faithful implementation of the FCD whereby certain implementation decisions were taken on the basis of the general scope of the FCD, namely the regulation of financial collateral arrangements. Thus, the opening statement of the FCAR consultation document on the implementation of the FCD focuses only on the establishment of a financial collateral arrangement regime and states that the approach taken in implementing the FCD: '[…] is to extend the scope and usefulness of financial collateral arrangements as widely as possible having regard to general UK policy on insolvency.'[25] This is also the case in relation to the personal scope of the FCAR which was extended to cover arrangements between two corporate entities as this was considered consistent with the overall policy objectives in UK law 'where many of the Directive's provisions already apply *irrespective* of the identity/capacity of the parties[…].'[26] Thus, the rationale for a wide personal scope of the FCAR does not seem to take into account the risk mitigation role played by close-out netting provisions, nor the effects arising from the privileged ranking granted to the netting creditor.[27] This state of affairs leads to the difficulty in defining the role and justification which the legislator intended to give specifically to the recognition of the close-out netting concept and in gauging the influence of insolvency set-off on the development of close-out netting under the FCAR.

8.3.1.3 Recognition 'In Accordance With Its Terms'

The implementation of the close-out netting provisions of the FCD was clearly influenced by the conviction that close-out netting provisions were already enforceable under English law. The FCAR consultation document provides that although there are no insolvency law provisions which need to be disapplied in order to give effect to Article 7(1) of the FCD, the

25 HM TREASURY 2003 FCAR Consultation Document, para 1.12.
26 *Ibid.* paras 2.2 and 2.3.
27 This view does not seem to be shared by the court in the *Cukurova* case already considered in Chapter 4.1 where it was held *obiter* that the wider the scope of the FCAR, the better the protection against systemic risk.

proposed FCAR includes a provision that close-out netting provisions are to take effect in accordance with their terms so as 'to deal with any doubts there may be about the effectiveness of such terms when a company becomes insolvent due to common law or equitable principles which could be used to undermine close-out netting provisions.'[28] This statement reveals two aspects of the intention of the legislator. The first is that consistent with the 1993 Financial Panel Statement, the legislator appears to be convinced that close-out netting provisions can be enforced in an insolvency situation, presumably under the rules of insolvency set-off, without the need for specific statutory recognition. Second, the legislator is also aware that limitations set by the same insolvency set-off rules was creating uncertainty in the enforcement of close-out netting provisions. Thus, it could not be certain if the courts would invalidate a close-out netting provision that went beyond the scope of the insolvency set-off rules on the basis that the parties were trying to contract out of the insolvency rules.[29] There is therefore the dichotomy under English law that the legislator considers close-out netting provisions were already enforceable under English insolvency law whereas English doctrine was concerned about the uncertainties of their enforceability. Rather than resolve these uncertainties by granting recognition to close-out netting provisions generally, the legislator chose to faithfully implement the material scope of the FCD and apply it to close-out netting provisions so that the implementation of Article 7(1) of the FCD which recognises close-out netting provisions in accordance with their terms, does so only in relation to those provisions which form part of a financial collateral arrangement or are related to it.

Other than for the wider personal scope, the FCAR faithfully reproduces the provisions of the FCD. In these circumstances, the question arises on how is it possible to trace the influence of common law in the development of close-out netting under English law? The answer lies mostly in the details of implementation. Regulation 12 of the FCAR which recognises the principle of party autonomy in close-out netting provisions is very detailed in its provisions, which is typical of the style of drafting of common law jurisdictions. The interpretation ambiguity associated with regulation 12 has already been dealt with in Chapter 4.3. It is also recalled that regulation 12 applies only to close-out netting provisions when winding-up proceedings or reorganisation measures are pending against one of the parties and these exclude resolution measures under the Banking Act.

The list of exceptions to the recognition of party autonomy enunciated in regulation 12(2) of the FCAR is 'homegrown' and is reminiscent of the exceptions provided in rule 14.25(6) of the Insolvency Rules 2016 which prohibit the setting off of claims when the solvent party had actual knowledge of the pending insolvency. This indicates both the influence which

28 HM TREASURY 2003 FCAR Consultation Document, para 5.9.

29 This discussion has been raised in Chapter 7.2.1.

set-off rules still exert over the development of close-out netting as well as the assimilation of rights and privileges associated with both set-off and close-out netting mechanisms. It is arguably for this reason that the legislator felt the need to balance the exercise of close-out netting rights with an obligation that the solvent party *should not be aware* of the commencement of insolvency proceedings. But the legislator went beyond in the case of close-out netting and imposed the obligation that the party *could not have been aware* that winding-up proceedings or reorganisation measures had been commenced against the other party. Although the notion of constructive knowledge is familiar to English legal doctrine, it has not been made applicable in relation to insolvency set-off. The condition of constructive knowledge is imposed by the FCD in its Article 8(2) in cases where the financial collateral obligation came into existence on the same day but after the moment of opening of insolvency proceedings. The English legislator has therefore taken a stricter approach towards the general recognition of close-out netting provisions than exists under both the FCD and the English rules on insolvency set-off which is arguably an indication of a new more equitable balance that the legislator is seeking to strike for the exercise of close-out netting rights.

Whilst regulation 12(2) imposes a number of conditions restricting the enforceability of close-out netting provisions, regulation 12(4) and other provisions of the FCAR seek to exempt the recognition of close-out netting provisions from the operation of specific provisions of insolvency law. Thus, rather than providing for a general derogation from the provisions of insolvency law as this was deemed not to be required for the enforceability of close-out netting provisions, the legislator opted to provide for specific derogations where uncertainties may have existed. The legislator is thus working on the assumption that close-out netting is generally enforceable and has sought to exclude those provisions of insolvency law giving rise to doubts as to its enforceability. In this respect, regulation 10(1) provides an exemption from section 127 of the Insolvency Act 1986 in relation to avoidance of property dispositions. Regulation 12(4) provides an exemption from certain provisions on insolvency set-off of the Insolvency Rules. Finally, regulation 14 provides modification rules for the conversion of currency under the Insolvency Rules.

This evidences a virtual break from the influence of insolvency set-off rules mainly in two ways. First the legislator did not deem it necessary to state that insolvency set-off rules in general do not apply since henceforth close-out netting provisions are enforceable in accordance with their terms. Second, where uncertainties remain such as in the conversion of foreign currency, specific modifications or exclusions were introduced. However, it has also been seen that some influence remains in the morality justification of close-out netting rights which, like set-off rights, bestow privileged rights to the creditor. For this reason, the legislator has imposed similar conditionality for the recognition of close-out netting rights relating to the lack of knowledge of the pending insolvency.

8.3.1.4 Congruence with State Insolvency Goals

In Chapter 4.4 it was recognised that the privileges associated with the exercise of close-out netting rights could be classified as a type of pre-insolvency contractual entitlement which is favoured by English common law. Similar to the protection of the privileges derived under insolvency set-off which are recognised by statute, the exercise of close-out netting rights under the FCAR cannot be stated to breach the *pari passu* principle and they are not considered a means of contracting out of insolvency law. However, it is not so straightforward to equate the privileges enjoyed by the party benefiting from close-out netting rights with those derived from insolvency set-off. Insolvency set-off, although operating with significant flexibility, is limited by statute in the fulfilment of its basic requirements and is generally enforceable subject to insolvency procedural law such as the requirement of the proof of claims. The ultimate justification for the enforceability of close-out netting provisions under the party autonomy principle is that the size of the parties and the extent of interconnectedness and exposure they have with each other merits the privilege given to the solvent party to close out and net its whole business relationship with its insolvent counterparty to avoid systemic risk. It is thus not only an asset of the insolvent estate which the unsecured creditors are being deprived of as in the case of insolvency set-off and even in the case of secured credit, but the whole insolvent estate could be significantly depleted on account of the exercise of close-out netting rights. As noted by Henderson in Chapter 4.2.2, the whole relationship of the two parties is privileged in a close-out netting arrangement, including any cross-product netting arrangements, and not just a single transaction. This effect is mainly brought about by the possibility given to the solvent party to terminate or accelerate all outstanding transactions on the sole basis that insolvency has occurred. As a result, the classification of close-out netting rights as a type of pre-insolvency contractual entitlement must be considered in the light of the wider implications this type of entitlement may have on the insolvent estate.

In sum, two main influences have been detected in the development of close-out netting under the FCAR. The first is the close association with insolvency set-off whereby similar conditionality for the exercise of close-out netting rights has been imposed, namely related to the lack of knowledge of the pending insolvency. This could indicate that close-out netting, like insolvency set-off, is also based on morality considerations. The second is the focus of the English legislator when transposing the FCD on the implementation of a liberal financial collateral regime which was widely drafted to render the London financial market more competitive globally.[30]

30 HM TREASURY 2003 FCAR Consultation Document, para 1.12.

As a result, the same scope of application for the financial collateral regime applies also to close-out netting provisions. Given that this scope of application includes agreements concluded between any two corporates, irrespective of considerations of systemic importance, it may be difficult to reconcile the development of close-out netting with a particular state insolvency goal other than the one pertaining to the English financial collateral regime, *i.e.* the competitiveness of London as a financial centre.

8.3.2 French Law

The close association under French law between close-out netting and the concepts of termination and set-off is evident in the terminology often used in doctrine to refer to the concept of close-out netting, *i.e.* '*résiliation-compensation*'. It does not appear debatable for French authors that close-out netting is indeed based on these two concepts. Thus, it has been noted in Chapter 5.2 that according to Roussille whilst the legislator had a choice to either create a *sui generis* mechanism or to adapt existing legal mechanisms, the legislator took the latter route by associating two mechanisms, namely termination and set-off allowing the counterparties to terminate operations in the case of a risk of insolvency and setting off amounts due to achieve a net sum payable.[31]

Notwithstanding the close association with the concepts of termination and set-off, contrary to English law the development of close-out netting under French law occurred from inception under *ad hoc* netting law. The close-out netting mechanism under the earlier netting laws consisted of two parts. First, the law permitted the setting off of financial obligations under the modalities of valuation set in the contract provided these were in line with the rules of relevant financial market associations or the terms of the national or international master agreements in place for that market. Second, termination of the transactions was only permitted in case of the insolvency of one of the parties. This was the case under the law of 1987[32] in relation to the securities lending market, the law of 1993[33] on the futures market and all relative amendments to the netting laws until the implementation of the FCD in 2005. Following the 2005 amendments,[34] the former article L.431-7 of the Financial Code referred equally to termination and set-off as the two elements comprised in the enforceability of close-out netting provisions whether within or outside of an insolvency situation. Thus, although it is evident that the close-out netting concept under French law is currently built on the concepts of termination and set-off, these elements are regulated by the rules or agreements of the market so that

31 ROUSSILLE (2001) 311.

32 See article 33 of Law No. 87-416 of 17 June 1987.

33 See Title III of Law No. 93-1444 of 31 December 1993.

34 See former article L.431-7 of the Financial Code as amended by Ordinance No. 2005-171 of 24 February 2005.

from inception close-out netting was subject to a type of 'self-regulation' by the market which was given recognition by law.

8.3.2.1 Relationship with Set-off

As noted above, the French legislator resorted to the idea of set-off to develop close-out netting but referred to the rules of the market to regulate its modality of operation. This raises the question whether any aspects of set-off, besides the economic one of achieving a single payment amount, also feature in the close-out netting concept. Both set-off and close-out netting are voluntary in nature and depend on the will of the parties to be put in operation. They serve specific, but different, purposes assigned by law. It has been seen in Chapter 5.2.1 that set-off under French law is a means of extinguishment of obligations whilst the provisions on close-out netting in articles L.211-36 *et sequentes* of the Financial Code have been placed under the heading '*Compensation et cessions de créances*' to describe the indemnification function performed by close-out netting.[35] Thus, close-out netting is a mechanism for contractual indemnification in the sense that it permits parties to establish by contract the modalities of valuation for the prejudice suffered from the early termination of the contract.[36] The respective laws have been drafted to achieve these purposes and do not appear to have generated controversial debate on the fairness or morality of the applicable provisions.

The fact that close-out netting developed under its own separate law, without being limited by set-off rules does not mean that the development of close-out netting was not influenced by the civil law system to which it belongs. Firstly, the reference to the modality of set-off in article L.211-36-1 of the Financial Code to refer to the method of achieving a net amount in itself indicates the close relationship between set-off and close-out netting in the mind of the legislator. However, it is surprising that with the resort by the market to other contractual methods of achieving a net amount, such as by novation, the legislator continues today to refer to set-off as the modality for achieving a net amount.[37] Second, civil law systems are traditionally monopolised by legislation. Party autonomy does not constitute an external source of law in a civil law system. With the emergence of new netting contracts in the financial markets, the French legislator promulgated legislation as early as 1987[38] to grant recognition to the close-out netting provisions of these contracts and thus ensure their enforceability. It is true that termination and set-off are the two main constitutive elements mentioned

35 The term '*compensation*' as used in this heading is not to be translated as set-off but as indemnification or reparation. The close-out netting provisions have been consistently placed under this heading since the enactment of article 52 of Law no. 96-597 of 2 July 1996 which was promulgated as the former article L.431-7 of the Financial Code.

36 See for instance CAILLEMER DU FERRAGE (2001) 5.

37 GAUDEMET (2010) para 468; AUCKENTHALER (2001) para 3.

38 Law no. 87-416 of 17 June 1987 on the securities lending market.

in the law and hence the reference to '*résiliation-compensation*', but from inception the legislator granted recognition to the contractual modalities of set-off provided these were in conformity with the provisions of the rules of the relevant financial market association or of the master agreements in place for that market.[39] Hence, from inception there was no direct influence of the rules of legal set-off on the development of close-out netting. This is also evidenced in the treatment of set-off and close-out netting in insolvency whereby claims arising pre-insolvency need to be connected for set-off to be allowed in terms of article L.622-7, I of the Commercial Code consistent with its function as a means of payment, whilst close-out netting enjoys an unconditional derogation from the application of insolvency law in terms of article L.211-40 of the Financial Code. It may thus be concluded that the influence on the recognition of close-out netting provisions under French law was conceptually from set-off but operationally from the market which managed to obtain statutory recognition of the termination, valuation and set-off modalities foreseen in its association rules or master agreements.

8.3.2.2 Scope of Application

It is expected that the scope of application of the close-out netting regime is affected by the specific purpose given to it by the French legislator as a contractual indemnification mechanism for the financial markets. The scope of application has been virtually changed with every amendment of the French close-out netting regime.[40] In relation to the material scope, the trend has always been to increase the scope of application to cover more markets. This was done either to cover new emerging markets or to resolve doubts whether existing markets, as in the case of the repo market, were adequately covered by the existing close-out netting regime. Notwithstanding this constant expansion, at the time of the implementation of the FCD it was considered that the material scope was still not sufficiently wide to cover the type of financial obligations falling within the material scope of the FCD and specific amendments were therefore required to remedy this limitation.

Whilst the material scope has been constantly widened, the personal scope has at times been widened and occasionally limited. In the 1987 regime, there was no particular status attached to the parties who could benefit from the close-out netting regime related to the securities lending market. In subsequent close-out netting regimes at least one of the parties had to be a designated financial institution, except for the global netting

39 See, for instance, Law No. 93-1444 of 31 December 1993 which introduces a new article 2 to the law of 28 March 1885 on the futures market providing that claims are to be set-off in accordance with the valuation modalities foreseen in the market association rules or the master agreement in place whilst termination may take place '*en plein droit*' in relation to those claims.

40 A review of the main amendments to the French close-out netting regime was made in Chapter 5.3.

regime adopted in 2001 where both parties were required to be designated entities.[41] In the 2005 amendments[42] to the former article L.431-7 of the Financial Code implementing the FCD, physical persons were excluded from the scope of the close-out netting regime, only to be reintroduced in the July 2005 amendments.[43] Even when implementing the FCD, the legislator chose a partial opt-out of the scope of application by adopting a wide material scope to cover obligations which in terms of Article 2(1)(f) of the FCD 'give a right to cash settlement and/or delivery of financial instruments' where both parties are designated persons, whilst reserving the narrower material scope relating to contracts on financial instruments listed in articles L.211-1 and L.211-36 of the Financial Code if only one of the parties is a designated person. The close-out netting regime, even after the FCD, remained separate from the financial collateral regime, the latter being regulated under article L.211-38 *et sequentes* of the Financial Code and as a result it is not necessary that a close-out netting provision forms part of a financial collateral arrangement to benefit from the regime of article L.211-36-1 of the Financial Code.

The frequent changes in particular prior to the implementation of the FCD imply that party autonomy was not considered as an external source of law and the developing markets required specific statutory recognition to ensure the enforceability of their close-out netting provisions. It appears that while the legislator was willing to increase the material scope of the law, albeit in a piecemeal manner, to allow for the recognition of close-out netting provisions in a wider range of contracts, this was not always the case in relation to the personal scope of the law. This is most evident in relation to the former article L.431-7 of the Financial Code as amended by the Law of 15 May 2001 which recognised the validity of close-out netting arrangements for financial instruments concluded by parties at least one of whom was a designated person, but only permitted global netting across different agreements if both parties were designated persons. A similar situation applies under the current law where a wider material scope is only possible if both parties are designated persons. The legislator was therefore more concerned to cover more products under the indemnification mechanism brought about by close-out netting, rather than protect the different range of parties contracting on those products.

It is not easy to explain the approach taken by the legislator. The willingness of the legislator to accommodate new markets could be considered in line with the contractual indemnification function which the close-out netting law is meant to perform, but it could equally reflect submission to the pressure of the markets to recognise more types of financial contracts and also the desire to remain competitive in this area of law which was generating legislative developments in other jurisdictions. In other words,

41 The restriction of the benefit of global netting to professional parties was made on the basis of an extensive debate in Parliament as has been referred to in Chapter 5.4.2.

42 Ordinance No. 2005-171 of 24 February 2005.

43 Law No. 2005-842 of 26 July 2005.

the influence of the *lex mercatoria* may have had a role to play in shaping the type of recognition granted to close-out netting under French law. In relation to the personal scope the legislator had probably more leeway to decide whether to take a more pro-debtor or pro-creditor approach once the close-out netting provisions of the financial market itself were already covered by the law. The widening and narrowing of personal scope arguably indicate the hesitation of the legislator to take a more pro-creditor approach and this is reflected in the implementation of the FCD which, as has already been stated, applies a narrower material scope if one of the parties is not a designated person. On the other hand, this approach does not help explain or justify why the law recognises even agreements concluded with physical persons given that this is excluded by the FCD and extends the purpose of the close-out netting regime beyond its original scope of indemnification for the financial markets. The extension of the close-out netting regime to physical persons is also arguably evidence that considerations of systemic risk were not taken into account when drafting these laws.

8.3.2.3 Recognition 'In Accordance With Its Terms'

Since the first close-out netting law of 1978[44] dealing with the securities lending market, the law, although amended on numerous occasions, continued to follow approximately the same style and sequence of provisions. Prior to the implementation of the FCD, former close-out netting laws provided that in respect of designated parties and designated financial contracts, the law will give effect to the contractual modalities of termination and set-off if these modalities conform to the rules of the relevant market association or of the master agreement in place nationally or internationally for that market.[45] Each law, including the current law, ends with the rule that third parties may not oppose the enforceability of such agreements by way of civil execution action and that insolvency law shall not affect their enforceability. Initially these laws focused on the modalities of termination and set-off, but valuation was soon added as another modality,[46] though it was understood *ab initio* that valuation according to the market association agreements and master agreements was already included in the set-off modality.[47]

44 Former article 33 of Law no. 87-416 of 17 June 1987.

45 One temporary exception applied in the case of repos where under article 12V of the law of 31 December 1993 the approval of the Governor of the *Banque de France* was required prior to enforcing close-out netting provisions of repo agreements. This exception could be explained by the loan-like features of repos which necessitated additional control on their enforcement. In any case, this control was deleted by the Law no. 96-597 of 2 July 1996.

46 The first mention of all three constitutive steps of close-out netting occurred in article 52 of Law no. 96-597 of 2 July 1996.

47 See, for instance, the new article 2 added by Law no. 93-1444 of 31 December 1993 to the Law of 28 March 1885 which provides that: '*Les dettes et les créances afferents aux marchés mentionnés à l'article 1er […] sont compensables selon des modalités d'évaluation prévues par lesdits règlements ou ladite convention cadre*.'

Although the scope of application of the French close-out netting regime was widened in 2005 to implement the provisions of the FCD and the reliance on the rules or master agreements of the market associations to give recognition to close-out netting agreements was deleted,[48] the legislator did not change the style of drafting of the provisions. As a consequence, since the French legislator continued to adapt existing legislation rather than create an *ad hoc* law when implementing the FCD, the principle that close-out netting provisions are enforceable in accordance with their terms does not appear *verbatim* in the French close-out netting law. Instead, the French legislator relied on the already available provisions providing for the enforceability of close-out netting provisions. This has been achieved in three ways. First, article L.211-36-1, I of the Financial Code permits the termination and set-off of eligible financial obligations in terms of one or more agreements or master agreements entered into between the parties. Second, paragraph II of the same article grants protection to the contractual modalities of termination, valuation and set-off against third party action under a civil execution procedure or a right of opposition. Third, article L.211-40 of the Financial Code provides, *inter alia,* that the provisions of insolvency law contained in Book VI of the Commercial Code should not hinder the applicability of the provisions mentioned above.

It may seem *prima facie* that these protections are tantamount to providing for the enforcement of a close-out netting provision in accordance with its terms. Whilst for the most part they are, it has already been seen in Chapter 5.3 that the absence of a general rule stating that a close-out netting provision will be enforced in accordance with its terms means that any restriction which cannot be classified as either third party action within the meaning of article L.211-36-1, II of the Financial Code or which does not fall under the derogations of article L.211-40 of the Financial Code may hinder the full recognition of close-out netting provisions.[49] Three such instances have been identified in Chapter 5.3, among them the conservatory acts that may be exercised by the ACPR under article L.612-33 of the Financial Code. It is arguable that the French legislator was convinced that party autonomy was adequately protected under the existing provisions of

48 These two aspects, namely the material scope and the reliance on market association rules or standard agreements are the two main issues requiring changes to the French close-out netting regime in order to implement the FCD. See *Rapport au Président de la République relative à l'ordonnance no 2005-171 du 24 février 2005 simplifiant les procedures de constitution et de realisation des contrats de garantie finacière*, NOR: ECOX0400308P. The widened scope of application following the implementation of the FCD may have altered, at least functionally, the purpose of the close-out netting law as an indemnification mechanism.

49 Former versions of the French close-out netting regime may be considered more adequate in fulfilling the standard that a close-out netting provision is enforceable in accordance with its terms. Thus, the close-out netting regime promulgated by Law No. 93-1444 of 31 December 1993 provided that: '*Les dispositions du présent article sont applicables nonobstant toute disposition législative contraire*', implying that no law could supersede the exercise of party autonomy as foreseen by the same close-out netting regime.

article L.211-36-1 of the Financial Code which has withstood the test of time, but it could be that new laws, not foreseen at the time when this article was drafted, could have an effect on the extent of recognition given to close-out netting provisions as provided by the FCD.[50] This is different from the situation where the legislator, as in the case of resolution regimes, expressly creates an exception or an alteration to the party autonomy principle of the close-out netting regime but is a case where unknowingly and on account of the nature of certain powers given under a separate law, these may supersede the provisions on close-out netting and thus restrict the extent of recognition granted. Thus, the fact that the French legislator may have opted to implement the FCD by relying on the previous recognition already granted to close-out netting arrangements and simply widened the scope of application may not have been sufficient to incorporate the party autonomy standard sought to be achieved by the FCD. This also brings out the difference in interpretation between a civil and common law jurisdiction. Whilst under English law the specific derogations from designated provisions of insolvency law was not interpreted to imply that other provisions of insolvency law continue to apply, under French law the general derogations from insolvency law and third party civil action have, to the contrary, been interpreted to imply that the application of other provisions of the law is not excluded.

8.3.2.4 Congruence with State Insolvency Goals

The lack of conditionality attached to both the recognition of close-out netting provisions and to the derogations from other laws is particularly noticeable. The FCD itself obliges Member States in Article 8(2) to ensure that in relation to financial obligations arising on the day but after the moment of opening of insolvency proceedings, the solvent party must prove that it was not aware nor could have been aware of the commencement of such proceedings. This obligation is not implemented in the close-out netting regime of article L.211-36-1 of the Financial Code. The French regime does not even set a time restriction when obligations subject to close-out netting should have been entered into to be considered enforceable so that both pre-and post-insolvency claims seem to be equally eligible.[51]

50 Although article L.211-40 of the Financial Code was slightly modified by Law no. 2019-287 of 20 April 2019 to exclude the application of article 1343-2 of the Civil Code on the compounding of interest, as noted in Chapter 5.1.

51 It may be recalled that in Chapter 5.4.1 it was noted that until the Act of 26 July 2005 only pre-insolvency creditors were subject to the constraints of insolvency proceedings whilst post-insolvency creditors were free to continue trading and enforce their security as this was considered necessary for the continuance of the business. This implies that the *pari passu* principle was at the time only applied to pre-insolvency creditors and may help explain the legal context in which the close-out netting regime applied.

Similarly, the derogation from the provisions of insolvency law in terms of article L.211-40 of the Financial Code is not subject to any restrictions such as relating to suspect periods or fraudulent transfers. Typical of a civil law jurisdiction, the law is what the legislator states it is and it does not seem that issues of morality or controversial debates on the effect of close-out netting on the *pari passu* principle under French law have arisen. However, the privileges granted in relation to close-out netting rights necessitate some balancing of interests and it cannot be the case that the law can permit the enforcement of close-out netting provisions for instance under fraudulent circumstances. In these situations, it will be up to the courts to give an equitable interpretation to the enforcement of close-out netting contracts on the basis of general principles of law to fill the gap left by the legislator.

This seemingly unconditional exercise of close-out netting rights without the imposition of restrictions evidently goes against the business rescue culture sought to be instilled by French insolvency law. It has been suggested in Chapter 5.4.2 that the direction taken by the French legislator in close-out netting may have been influenced by the public policy of the Government that the French economy should remain competitive within the global market. This trend is visible throughout the various amendments of the close-out netting regime which relied heavily on market rules and agreements for the recognition granted to party autonomy. In addition, it appears that the main point of discussion focussed on the personal scope of application and to what extent it should include persons outside of the financial markets. This may be an indication that although the French legislator was influenced by the public policy of the French government of the time to remain competitive in the market by providing more protection to close-out netting agreements entered into by the financial market, it is arguably an indication that the legislator still wanted to retain some restrictions in relation to the type of parties benefitting from such protection possibly in order to keep to the original purpose of the close-out netting of an indemnification mechanism for the financial markets. This trend, as will be seen in more detail later in this chapter, has been maintained in the partial opt-out exercised by the French legislator when implementing the personal scope of the FCD.

8.3.3 US Law

Under US law the recognition of close-out netting provisions was borne out of the notion of the safe harbours of the Bankruptcy Code. Prior to the enactment of section 560 of the Bankruptcy Code, the safe harbours protected only the close-out aspect of financial transactions, allowing parties to designated contracts to terminate open market positions upon the insolvency of one of the parties. With the enactment of section 560 in 1990 the Bankruptcy Code recognised in addition the offset and netting of termination values in relation to swap agreements. This historical development of close-out netting under US law may have influenced the perspective taken in US doctrine that close-out and netting are two separate contractual rights.[52] Indeed, contrary to the French legislator who at the outset combined two existing concepts, namely termination and set-off, to create a new concept, *i.e.* close-out netting, the US legislator set out to protect designated contractual rights from the application of insolvency law, which included the separate rights of close-out and netting. Two remarks may be made on the historical evolution of close-out netting. First, since the original safe harbours granted protection only to the close-out of financial transactions,[53] it can be argued that the solvent creditor had to resort to ordinary set-off rights, where applicable, to reduce its exposure to a net amount. Second, it may be noted that the protection of the contractual rights of offset and netting when combined with a close-out of the designated agreement was introduced in 1990 *via* section 560 of the Bankruptcy Code in relation to swap agreements at a time when the derivatives industry led by ISDA was lobbying worldwide for the introduction of close-out netting legislation. Further reflections on both issues are made below.

8.3.3.1 Relationship with Set-off

It has been stated in Chapter 6.2.2 that ordinary set-off did not influence the development of close-out netting under US law given that the latter developed under the different notion of the safe harbours. The beginnings of set-off under both English and US laws were similar, in that both began as pleading tools to avoid multiplicity of actions and later were considered as a substantive concept and a form of security, based on equity considerations. However, whilst under English law insolvency set-off developed into a mandatory concept which operated with flexibility and was initially resorted to for the protection of close-out netting provisions, under US law set-off is of a voluntary nature and operates rather inflexibly upon insolvency where court intervention is often required for its enforceability. Arguably, US ordinary set-off law was not considered a suitable model to resort to for the protection of close-out netting provisions and hence did not influence its development.

However, what is rather unexplainable is the sudden severance of the link with ordinary set-off when creating the safe harbour protection of the contractual rights of offset and netting. Thus, to contrast with the French position, the reference to set-off in article L.211-36-1 of the French Financial Code as one of the constitutive elements of close-out netting is the same reference to contractual set-off regulated by the provisions of the Civil Code but adapted in order to provide enhanced protection to party autonomy in the recognition of close-out netting provisions. US law, on the

52 See, for instance, BLISS & KAUFMAN (2006) 58. The consideration of close-out and netting as two separate rights, and not as constituting a single concept, was discussed in Chapter 6.2.

53 11 U.S.C. §§ 555, 556, 559.

other hand, has created a different concept of offset in section 560 of the Bankruptcy Code which achieves the same result as ordinary set-off, *i.e.* a single payment amount, but has developed it on the basis of the separate notion of the safe harbours. This separation between ordinary set-off and close-out netting under the Bankruptcy Code indicates that the US legislator was not influenced by the legal doctrine and the pro-debtor influence that could have been exerted by ordinary set-off law.

It is more difficult to ascertain whether the same severance from ordinary set-off also applies to the term 'netted' used in section 403(1) of FDICIA since the terminology of this provision is similar to that used in modern close-out netting legislation such as the EU's FCD. This issue is unclear because the reference to offset is missing from this provision and this could be interpreted to mean that any setting off of obligations to achieve a net amount taking place under section 403(1) could be referring to ordinary set-off rather than to offset as understood under the safe harbours. However, the preferred view taken by this research is that with the adoption of the safe harbours and the immediate severance this brought from the influence of ordinary set-off, it seems hardly likely that with the introduction of FDICIA, which is arguably meant to modernise the close-out netting regime, the legislator would decide to turn back the clock and re-introduce the requirements of ordinary set-off.

Not only did the US legislator sever links with ordinary set-off when creating the safe harbours so that the same philosophy of ordinary set-off is not meant to apply to close-out netting, but it is also not clear what statutory purpose has been given to close-out netting. Since resort cannot be had to ordinary set-off to get an indication of this purpose, reference will be made to the positioning of close-out netting under US law. A consideration of the placements of the provisions of the two close-out netting regimes does not provide a consistent picture of the purpose sought to be achieved by close-out netting. The safe harbours of the Bankruptcy Code are placed under Subchapter III of Chapter 5 dealing with 'The Estate' of the insolvent debtor. This does not reveal the specific purpose of close-out netting but has probably been placed there by the legislator since the safe harbours are actually providing protection to designated contractual rights from the provisions of the Bankruptcy Code. The close-out netting provisions of FDICIA are placed under Subchapter 1 dealing with 'Bilateral and Clearing Organization Netting' in Chapter 45 on 'Payment System Risk Reduction' of Title 12 of the US Code on Banks and Banking. The placing of the bilateral close-out netting regime applying generally to the financial market in a chapter on payment systems also does not help to provide a clear indication of the specific purpose assigned by the legislator to bilateral netting. Possibly, the placement of the bilateral close-out netting regime under a chapter on payment system risk reduction may imply that the bilateral close-out netting regime in the mind of the legislator serves a risk mitigation purpose which is a rather generic purpose (*i.e.* not a functional purpose) and only helps to an extent to understand the direction or influence which the purpose may exert on the US legislator when granting recognition to close-out netting provisions.

8.3.3.2 Scope of Application

The personal and material scope of application of the two close-out netting regimes may shed more light on the purpose given to these regimes under US law and the influences which guided the legislator in the recognition of close-out netting. It has been seen in Chapter 6.2 that the close-out netting regime of section 560 of the Bankruptcy Code applies to swap agreements which are widely defined to include a vast range of derivative arrangements, and any transaction which is similar to these arrangements and any collateral and other credit enhancements.[54] It also applies to any swap participant or financial participant. Swap participant includes any entity which has an outstanding swap agreement with the debtor at any time before the filing of the bankruptcy petition[55] and a financial participant has to fulfil a number of threshold requirements as seen in Chapter 6.3 which indicate that it is a major market player.[56]

Two remarks may be made about the scope of application of section 560. First, consistent with the previous safe harbours but rather different from the close-out netting regimes of England and France which protect close-out netting provisions in financial arrangements related to designated financial instruments, the protection is granted to close-out netting rights derived from a particular agreement. The impression is given that the US legislator wanted to protect a particular market, namely the derivatives market, even perhaps to the detriment of leaving out segments of the financial market which cannot fall within this definition such as the repo market. It may also be noted that the list of agreements that constitute a swap agreement and the wording used to expand the meaning to equivalent agreements is reminiscent of the wording used in the successive ISDA Model Netting Laws to define a qualified financial contract.[57] These two elements, *i.e.* the focus on the derivatives market and the manner of defining swap agreements, is arguably an indication of the influence of ISDA on the enactment of section 560.

Second, the personal scope may include either a party to the swap agreement, which could be any entity, or a financial participant which has to fulfil certain threshold criteria. Since any party to a swap agreement may qualify for protection, it appears superfluous to refer also to a party fulfilling threshold criteria. Perhaps one can here detect a conflict between the influence of the ISDA Model Law which also offers protection to any

54 11 U.S.C. § 101(53B).
55 11 U.S.C. § 101(53C).
56 11 U.S.C. § 101(22A).
57 See ISDA 2018 Model Netting Act, Part 1 (‘Definitions’). Previous versions contained similar wording.

party to a qualified financial contract and the risk mitigation role performed by close-out netting under US law which influenced the purported restriction to major market dealers.

Section 403 of FDICIA is an attempt to bridge the gap where the Bankruptcy Code safe harbours do not adequately protect close-out netting provisions in relation to certain financial contracts. It attempts to do so in two ways. First, section 403 does not impose any restriction on the type of netting contract that is covered by this provision[58] so that the material scope is open. This is rather unusual and cannot be clearly attributed to either the influence of the drafting of the safe harbours or of the rules or standard agreements of market associations. It may also be incidental to the fact that the definition of 'netting contract' in section 402(14) of FDICIA covers also rules and agreements of payment systems and clearing organisations so that the legislator considered it practical not to limit the material scope of the definition in order to cover a wide range of netting contracts and thus cater for the wider scope of FDICIA.

Second, FDICIA limits the type of financial institutions that may be parties to a netting contract. A financial institution is defined as 'a broker or dealer, a depository institution, a futures commission merchant, or any other institution as determined by the Board of Governors of the Federal Reserve System.'[59] It may be noted that the list of financial institutions mentioned in this definition is an unmistakable reference to the types of parties covered by the safe harbours preceding the enactment of section 560 of the Bankruptcy Code which did not receive adequate protection of their close-out netting provisions. It is also to be noted that the Federal Reserve Board determined through the issue of Regulation EE[60] that a financial institution qualifies for protection of their netting contracts if it meets the same business thresholds set for the qualification of 'financial participant' referred to in section 560 of the Bankruptcy Code. The end result is therefore that on account of the high thresholds which a party must fulfil in order to qualify as a financial participant, an element of systemic risk may have been instilled by FDICIA since arguably only major market dealers qualify under this regime, whatever the type of netting agreement, and provided both parties are considered financial institutions, whilst the section 560 regime of the Bankruptcy Code is open to any party (being any entity) to a swap agreement.

The various influences which have shaped the US close-out netting regime have resulted in different levels of protection given to close-out netting provisions depending on the scope of application of the particular

58 In this respect, see the definition of 'netting contract' in section 403(14)(A) of FDICIA which refers, *inter alia*, to 'a contract or agreement between 2 or more financial institutions, clearing organizations, or members that provides for netting present or future payment obligations or payment entitlements […] among the parties to the agreement […].'

59 12 U.S.C. § 4402(9).

60 Regulation EE, 12 C.F.R. § 231.

regime. In terms of scope of application, those most widely protected are parties to swap agreements since any entity to a derivatives arrangement may benefit, while parties to other netting contracts are required to fulfil the thresholds established for a financial institution to get protection under FDICIA. Other than general statements made by Congress that safe harbours are required to instil public confidence in the respective markets and to protect against systemic risk,[61] there does not appear to be a particular justification why swap agreements, which have been widely defined to cover the derivatives market, should be given preferred treatment over other markets such as the repo market. One plausible explanation given above is the influence and pressure exerted by derivative market associations such as ISDA on the US legislator at the time of the enactment of section 560 of the Bankruptcy Code. Another could be the global expansion of close-out netting legislation at the time of the adoption of the FCD which could have led to the expansions of all the safe harbours in 2005 through the widening of definitions in BAPCPA. It will be seen below whether these same influences have also resulted in different levels of recognition granted under the different close-out netting regimes.

8.3.3.3 Recognition 'In Accordance With Its Terms'

It has been noted that when enacted in 1990 section 560 of the Bankruptcy Code followed the style of drafting of the existing safe harbours. A number of consequences follow from this situation. In some respects, the recognition given to close-out netting provisions seems quite wide. Thus, the protection is of a contractual right of a swap participant or financial participant. *Prima facie* there does not seem to be the imposition of any mutuality requirement, though it was argued in Chapter 6.2.2 that this is most probably due to the linguistic construction of the provision which protects contractual rights rather than netting contracts and should not be read to imply that mutuality is not required. Following the style of the preceding safe harbours, the source of a contractual right is widely defined to include not only rules and contracts of market associations, but also any right 'whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.' There is no link or reference in section 560 itself to the taking of resolution measures under other laws which could affect the operation of a close-out netting provision, although it should be recalled that bankruptcy proceedings of banks are regulated by FDIA and not the Bankruptcy Code. In other respects, however, the influence of the existing safe harbours has restricted the party autonomy role.

61 See KRIMMINGER (2006).

Thus, because it is influenced in its drafting by the preceding safe harbours the protection given to close-out netting is only from the application of the stay, avoidance and other titles or procedures under the Bankruptcy Code.[62] This protection does not seem to extend, for instance, to the actions that may be instituted by third party creditors outside of bankruptcy proceedings, as is the case under article L.211-36-1, II of the French Code. By international standards this protection may be considered rather limited, in particular taking into account that section 560 of the Bankruptcy Code does not contain the standard that close-out netting provisions are to be effective in accordance with their terms. These *lacunae* were taken up by the US legislator when drafting section 403 of FDICIA.

It will be recalled that the provisions of section 403 of FDICIA apply to any netting contract entered into between any two financial institutions that meet the business thresholds set by Regulation EE which would qualify them as systemically important entities. This provision seems to cater for all the restrictions and empowerment contained in a modern close-out netting regime based on international and market principles. It applies solely to mutual netting contracts ('between any 2 financial institutions') which 'shall be terminated, liquidated, accelerated, and netted in accordance with, and subject to the conditions of, the terms of the applicable netting contract.'[63] The notion of offset, referred to, and probably also created, by section 560 of the Bankruptcy Code, does not feature in section 403 of FDICIA and it is not clear if it continues to apply through a wide interpretation of the modality of netting. This may be contrasted with other laws, such as French law, which continues to refer to set-off as a generic modality for achieving a close-out amount. The party autonomy enjoyed by financial institutions is made to apply '[n]otwithstanding any other provision of State or Federal law' subject only to the supremacy of resolution and other conservatory measures and orders which may be taken under designated provisions. This ensures that, save in the exceptions mentioned by section 403(a) of FDICIA, the effectiveness of a close-out netting provision is ensured *erga omnes* since the derogation applies not only from bankruptcy law but any other law including those that may give third party creditors the right to impugn a close-out netting provision.

Further repercussions on the recognition granted to close-out netting provisions arise from the style of drafting of the netting regimes. Thus, reference is still made today in section 560 and the other safe harbours of the Bankruptcy Code under the meaning of 'contractual right' to the rules and bylaws of market associations or the terms of their market agreements, including rights 'whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.' Although this wording is reminiscent of the type of wording

62 The derogation does not apply to fraudulent transfers with actual intent to hinder, delay or defraud creditors as foreseen in Chapter 6.2.2.

63 12 U.S.C. § 4403(a).

used under the former article L.431-7 of the French Financial Code referring to the terms set by the rules of market associations (which has now been removed), section 560 of the US Bankruptcy Code goes much further and grants important derogations from the insolvency law even to rights derived from unwritten agreements and customary law. It is difficult to understand why this wide scope of contractual rights has remained constantly applicable throughout the expansion of the safe harbours and today applies to the protection of close-out netting under section 560 of the Bankruptcy Code. Although US law, being partly based on the common law system, may recognise customary law as a source of law, it is difficult to explain the reason for the continued recognition of contractual rights arising from this source and from unwritten agreements, given the significant effect of the derogations from insolvency law. The continued retention of this reference cannot nowadays be the result of the pressure exerted by market associations since the type of complex agreements covered by section 560 of the Bankruptcy Code are covered either by master agreements or, at most, by written rules or bylaws of financial market associations but not by unwritten agreements. It would thus seem that the legislator has retained in place a wide definition of the source of contractual rights which was contained in the previous safe harbours without reassessing whether this continues to be justified or necessary.

Section 403 of FDICIA, on the other hand, portrays a completely different style from section 560 of the Bankruptcy Code. The subject matter, and therefore the focus, of section 403 is the protection of a netting contract, as opposed to section 560 where the protection centres on contractual rights, not necessarily forming part of a netting contract. Although varying in material and personal scope, the drafting of section 403 is reminiscent of the drafting of Regulation 7 of the FCD, including the standard that a close-out netting provision is to be enforceable in accordance with its terms.

To an outsider, there is little logic why the US legislator enacted two separate, but overlapping, netting regimes in a short span of time except to assume that the legislator was under pressure to enact close-out netting legislation in this piecemeal fashion. In 1990, when the derivatives industry was proliferating, the US legislator enacted section 560 to protect close-out netting provisions in swap agreements which was amended in 2005 by BAPCPA to, *inter alia*, increase the type of agreements that could be protected. In 1991, the US legislator enacted section 403 of FDICIA which, albeit restricted to major market players only, is meant to apply to all financial contracts concluded by the designated financial institutions. It has been discussed in Chapter 6.3 that FDICIA was meant to cover those transactions which did not fall within the definition of swap agreement, in particular those transactions covered by the safe harbours preceding the enactment of section 560 of the Bankruptcy Code. It is not clear which is the *lex specialis* between the two netting laws for the parts where they overlap since the section 560 regime is more specific on the type of agreements covered by the safe harbour whilst FDICIA is more specific on the designated parties.

It would seem that the opportunity was lost for the US legislator when enacting FDICIA to unify all the existing safe harbours into one regime and thus resolve the current overlap between the existing regimes.

8.3.3.4 Congruence with State Insolvency Goals

It has been seen in Chapter 6.4 that the US legislator adopts a particularly conservative and pro-debtor approach to protect the value of the estate. As a general rule the commencement of bankruptcy proceedings acts as an automatic stay against the enforcement of any lien against, or the offset of any debts owed to, the debtor.[64] Therefore, all creditors are prohibited from removing or using any part of the debtor's estate to satisfy their claims. Each creditor must file a claim and then wait for the bankruptcy trustee to distribute the debtor's estate to satisfy each claim.[65] In addition, an executory contract of the debtor may not be terminated based on the financial condition of the debtor or the commencement of a bankruptcy case.[66]

In the light of these and other pro-debtor insolvency rules considered in Chapter 6.4, and given the different approaches of the two close-out netting regimes, it may be difficult to establish a single purpose or state insolvency goal which explains the type of recognition given to close-out netting provisions under these two regimes. The broad scope of application and the wide derogations applicable under both the section 560 Bankruptcy Code regime and the FDICIA regime are hard to compare with, for instance, the inflexible rules of ordinary set-off and the extent of court intervention required to both terminate executory contracts as well as to set off mutual claims upon bankruptcy. The focus of the section 560 regime is on the protection of close-out netting provisions in swap agreements from the provisions of the Bankruptcy Code, whilst that of FDICIA is the protection of close-out netting provisions in any type of financial contract concluded by systemically-important financial institutions from the provision of any law with the exception of specified resolution and conservatory measures. Apart from the type of derogations being granted which has already been discussed above, the fact that the legislator has switched from protecting the type of market, albeit widely defined to include most of the derivatives market, to protecting systemically important financial market players in a span of one year gives an indication that the US legislator was not focused on a particular insolvency goal or public policy, but was rather influenced by the expansion of the derivatives market by first offering protection to the derivatives industry in section 560 and then to its major members in the FDICIA regime, but taking into account the supremacy of resolution and conservatory measures. This influence is made more evident by the fact that the legislator did not consider the necessity of amalgamating the

64 11 U.S.C. § 362(a).
65 11 U.S.C. § 704.
66 11 U.S.C. § 354(e)(1)(A).

two regimes to establish a single focus of the close-out netting regime but, as with the preceding safe harbours, continued enacting law to meet the developments and give in to the pressure of the market.

8.4 Recognition by EU Law of Close-out Netting Provisions

A major influence on the close-out netting regimes of England and France is undoubtedly the adoption of the EU's Financial Collateral Directive. Both jurisdictions, as did the other EU Member States, transposed the provisions of the FCD into domestic law, including its Article 7 on the recognition of close-out netting provisions. The interpretation of the close-out netting provisions under both the FCD and the BRRD has been examined in Chapter 3. This part will analyse how the minimum level of recognition of close-out netting provisions required to be implemented by the FCD has influenced the development of the close-out netting regimes of England and France.

The FCD was adopted in June 2002 and was primarily intended to introduce an EU framework for financial collateral to harmonise the significant discrepancies in the laws of the EU Member States insofar as regards the formalities required to enforce a title transfer and a security-type of collateral arrangements. The FCD therefore is limited in scope to financial collateral arrangements entered into between designated entities. No business or size thresholds have been set by the FCD for the eligibility of the entities that may benefit from the Directive since, given the primary purpose of harmonising the EU framework for financial collateral, none were required. As a secondary issue, the FCD also seeks to harmonise the recognition of close-out netting provisions typically contained in the financial collateral arrangements falling within the scope of the FCD.[67] As a consequence, the scope of application of Article 7 of the FCD is the same as that intended for the harmonisation of the formalities of financial collateral arrangements.

It is worth noting that Recital (14) which provides a justification for Article 7 refers to the need to maintain '[s]ound risk management practices' and to enable counterparties 'to manage and reduce their credit exposures', but does not appear to contemplate the protection against systemic risk which is more typically associated with the size, volume of business and interconnectedness of a counterparty. Whilst it will be discussed below how this has influenced the English and French regimes, it would seem that should a Member State introduce a type of size threshold or interconnectedness or other similar consideration for the recognition of close-out netting

67 In terms of the European Commission's *Working Document on Collateral from the Commission to relevant bodies for consultation*, 'The form of netting which is particularly linked to collateral arrangements is "close-out" netting, which forms a key part of the enforcement mechanism for repo and other title transfer collateral arrangements.' EUROPEAN COMMISSION 2000 Working Document, 13.

provisions in accordance with their terms, it is questionable whether this would meet the minimum harmonisation standards set by the FCD and as such not be considered as fully implementing this Directive.

On the other hand, as a type of minimum harmonisation instrument, Member States may go beyond the requirements of the FCD. The standard set by Article 7(1) of the FCD is to grant recognition to a close-out netting provision in accordance with its terms notwithstanding the existence of winding-up or reorganisation proceedings of the counterparty and notwithstanding any purported assignment or attachment in relation thereto. Thus, as a minimum Member States should provide derogations to protect close-out netting provisions from their insolvency laws and from third party (civil) action. It appears that protection to a close-out netting provision should be acceptable up to the day of, and even after the moment of commencement of, insolvency proceedings. This may be implied from a reading of Article 8(2) of the FCD which provides that in such cases the solvent party is required to prove that it was not aware, nor could have been aware, of the commencement of such proceedings. The presumption is that after the day of the commencement of insolvency proceedings, any financial transaction entered into is deemed to be done in bad faith.

The standard set by the FCD for the recognition of close-out netting provisions is subjected to two exceptions. Article 4(6) of the FCD recognises and gives pre-emption to 'any requirements under national law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commercially reasonable manner.' In the same vein, Recital (15) provides that the FCD is to apply without prejudice to 'any restrictions or requirements under national law on bringing into account claims, on obligations of set-off, or on netting', citing as examples of these restrictions the requirement of reciprocity and the lack of knowledge or constructive knowledge of the imminent or pending insolvency. It is understood that at the time of its introduction, the FCD was going to bring about significant changes in the laws of the Member States, in particular those which still relied on the pledge regime for collateralising their financial transactions or had to rely on foreign governing laws to conclude repo agreements. These exceptions gave the opportunity to national legislators to introduce national restrictions which could affect the standard for party autonomy set by Article 7(1) of the FCD without violating mandatory or public policy national laws.

Clearly, the FCD establishes a broad framework for the recognition of close-out netting provisions which permits variation in its implementation and retention of certain national restrictions. This is to be contrasted with the scope of application of the same regime which, even though wide, Member States are expected to implement as a minimum. It is thus to be expected that whilst the manner in which the Member States have implemented the standard for the recognition of close-out netting provisions could vary significantly, the scope of application should be implemented at least as stipulated in the FCD. Whilst general remarks have already been made in part 8.3 of this chapter on the way in which the FCD has influenced the development of close-out netting in England and France, this part will compare these influences in terms of scope of application, type of derogations granted to protect party autonomy and the retention or introduction of national law restrictions. A few observations of how the FCD may have also influenced the development of the safe harbours in the US will be made at the end.

8.4.1 Scope of Application

By far the greatest influence of the FCD on English law is that it instigated the English legislator to enact close-out netting legislation in terms of the FCAR. Although the general conviction of the legislator was that close-out netting was already effective under common law, the transposition of the FCD was taken as an opportunity to address any uncertainties arising under equity or common law. Because a close-out netting statute did not exist prior to the transposition of the FCD, the scope of application of the FCD has had a profound influence on the development of English close-out netting law. The English legislator adopted faithfully the material scope of the Directive, as already explained in part 8.2 of this chapter, possibly acting under the conviction that a wider scope for the effectiveness of close-out netting was already operative under common law. As a result, the close-out netting regime is restricted to financial collateral arrangements as defined by the FCD and hence the certainty achieved by the statutory recognition of close-out netting under English law is also limited in this way. On the other hand, the English legislator chose not to be confined by the minimum requirements of the FCD in relation to the personal scope of application which was extended to include financial collateral arrangements entered into not only with designated entities, but also between any two corporate entities. This approach was based on the understanding that since no formalities applied under common law in relation to financial collateral arrangements concluded between any two persons, it was only logical to extend the personal scope beyond the confines of the FCD. In this way, the personal scope of close-out netting arrangements was automatically and similarly extended.

In France the transposition of the FCD resulted in the widening of the scope of application of the existing French close-out netting regime. Two important aspects had influenced the scope of application of the French close-out netting regime prior to the implementation of the FCD. It will be recalled that the French regime was based on the recognition of close-out netting provisions in designated markets when these provisions adhered to the rules of relative financial market associations or the terms of national or international master agreements in place for those markets. Another issue was the debate on the extent of the personal scope of the close-out netting regime to non-professional entities. For instance, it has been seen that although it was the general rule that the close-out netting regime would cover an entity dealing with any eligible person, the global netting regime was initially restricted to two professional entities contracting with each other. It is with these specific issues in mind that the French legislator implemented the FCD. The French legislator transposed the close-out netting provisions of the FCD separately from those on financial collateral arrangements and continued to amend the existing close-out netting regime of former article L.431-7 of the Financial Code[68] so that under French law the recognition of close-out netting is not restricted to financial collateral arrangements.

The obligation to transpose the FCD implied that the French legislator had to widen the material scope of the close-out netting regime. This meant that both the type of financial instruments covered by the regime had to be widened whilst the limitation relating to the adherence to the terms of the master agreements in place for the particular market had to be removed. The debate on the personal scope of the regime continued for the French legislator when implementing the partial opt-out permissible under Article 1(3) of the FCD. This is not a straightforward opt-out in the sense that legal entities have been excluded from the personal scope. Indeed, the concern of the French legislator with the personal scope is evident from the fact that a partial opt-out was adopted whereby the wider material scope of the FCD involving any contract regarding financial obligations for payment or delivery of financial instruments applies if both parties are eligible persons whilst the narrower material scope limited to contracts on specified financial instruments applies if only one party is eligible. In addition, when implementing the FCD, former Article L.431-7 of the Financial Code expressly excluded physical persons from this regime in line with Article 1(2)(e) of the FCD. However, this exclusion was later omitted so that until today both physical and legal persons may benefit from the close-out netting regime if contracting with an eligible person. Two possible explanations may be given for this development. The first is that prior to the implementation of the FCD physical persons contracting with an eligible person were not excluded and the second might be a competitive one which ensures that the French regime can reach a wider range of participants. Thus, other influences, besides that of the FCD, have shaped the scope of application of French close-out netting legislation.

8.4.2 Type of Derogations

The two types of derogations foreseen by Article 7(1) of the FCD required to protect the enforceability of close-out netting provisions are from the application of insolvency laws and from third party action, these being recognised as possibly the two most problematic areas of law for such enforceability. Thus, ignoring for the moment the possibility given to

68 Amended by Ordinance No. 2005-171 of 24 February 2005.

Member States to introduce or retain certain national law restrictions, this is the type of protection to close-out netting which is required to be harmonised in the EU for the recognition of close-out netting provisions.

The English legislator transposed almost *verbatim* the rule in Article 7(1)(a) of the FCD that a close-out netting provision shall take effect in accordance with its terms notwithstanding the commencement or existence of insolvency proceedings in regulation 12(1) of the FCAR but omits to mention anything about protection against third party action as provided in Article 7(1)(b) of the FCD. This is one of the instances where the English legislator did not implement a provision of the FCD because there was no need to. Yeowart *et al.* explain that there is presumably no need to implement this part of Article 7(1) since 'this would be the case in any event as a matter of English law', although they also admit that probably there was also no need to implement the first part of Article 7(1) since the general understanding under English common law is that close-out netting already worked.[69] It has been stated, however, that the fact that English law implements the first part of Article 7(1) has resolved a number of uncertainties. If at the time of implementation of the FCD there were no risks that third party action could hinder the enforceability of close-out netting provisions, it is arguably the case that the English legislator was free to decide not to implement that provision because there was no need to. However, it would be good policy to have inserted a general provision to protect close-out netting provisions from third party action since this is also a safeguard against future legislative developments which could not be foreseen at the time of adoption of the FCAR.

In relation to the protection from the application of insolvency law, the English legislator (unlike the French legislator) was not content to formulate the general rule that close-out netting provisions apply notwithstanding the commencement or existence of insolvency proceedings, but opted to disapply or modify the application of certain provisions of insolvency law, in particular as regards the provisions on insolvency set-off.[70] Without re-entering into the interpretation problems caused by this exclusion or modification of certain insolvency law provisions as this has been sufficiently dealt with in Chapter 4, this indicates that notwithstanding the assumptions made by the English legislator in the FCAR Consultation Document on the recognition of close-out netting under English common law, the English legislator still felt the need to resort to these exclusions or modifications to bring legal certainty on the recognition of close-out netting provisions. This detailed type of regulation arguably reflects the common law style of drafting where the legislator does not rely on the interpretation of general principles of law but regulates all the details deemed necessary to implement those general principles. The drafting also reflects the conviction

69 YEOWART *et al.* (2016) 222.
70 See regulations 10(1)(b), 12(4) & 14 of the FCAR.

of the legislator that close-out netting is generally protected from insolvency law but, for certainty's sake, certain insolvency law provisions have been excluded or modified to avert any doubts as to their applicability.

The situation under French law appears to be more straightforward. Prior to the FCD, the former article L.431-7 of the Financial Code[71] provided that debts on financial instruments could be set off if adhering to market association rules or the general terms of standard market agreements, and operations could be terminated notwithstanding the provisions of insolvency law (*i.e.* book VI of the Commercial Code). The law also envisaged that the contractual modalities of termination, valuation and set-off are enforceable against third parties instituting civil execution action. Thus, the implementation of the FCD derogations did not require drastic changes in substance. The reference to the enforceability of close-out netting provisions notwithstanding third party action was retained and the exclusion of close-out netting provisions (and not only their termination aspect) from the provisions of book VI of the Commercial Code was inserted in a new article L.431-7-2.[72] The French legislator did not deem it necessary to adapt the law to stipulate that close-out netting provisions are to take effect 'in accordance with their terms' as provided by Article 7(1) of the FCD, no doubt having considered that the recognition of the termination and set-off of financial obligations and the derogations provided are sufficient to meet this standard. Thus, the French legislator only adapted the existing close-out netting law where it might be considered in breach of the FCD but otherwise continued to resort to existing legislation to implement the FCD.

8.4.3 Retention of National Law Restrictions

The FCD, as stated above, permits Member States to retain two types of restrictions which may affect the recognition of close-out netting provisions. The first is stipulated in Recital (15) and permits Member States to retain restrictions or requirements on bringing into account claims, on obligations to set-off or on netting. Under this restriction Member States may for instance retain any restrictions which under national law would serve to justify on moral and equity grounds a restriction of the recognition of close-out netting provisions. The second is provided by Article 4(6) and regards the possibility to retain avoidance actions on the grounds that the valuation or realisation of assets has not been conducted in a commercially reasonable manner. The implementation of these parts of the FCD could not have produced more contrasting results that those of England and France. Whilst the substantive issues regarding any national law restrictions which could

71 As modified by Law no. 2003-706 of 1 August 2003.

72 See Ordinance No. 2005-171 of 24 February 2005 and Law No. 2005-842 of 26 July 2005. Today these derogations are contained in articles L.211-36-1, II and L.211-40 respectively of the Financial Code.

affect the role of party autonomy have been dealt with in Chapter 7.2.2, this part will comment on the influence of the legal system in the implementation of these restrictions.

The English legislator resorted to both types of restrictions when implementing the FCD. In relation to Recital (15) of the FCD, regulation 12(2) of the FCAR introduces a number of conditions in order to permit the enforceability of close-out netting provisions upon insolvency which mainly regard the lack of actual or constructive knowledge of the imminent or pending insolvency proceedings. Two sources of influence of common law may be detected in this approach. The first is the presence of morality concerns of the legislator to ensure an element of fairness in the recognition of close-out netting provisions and the privileges ensuing therefrom. The second is the influence of the mandatory rules of insolvency set-off which also impose similar requirements on the lack of actual knowledge of a pending insolvency proceeding. In relation to Article 4(6) of the FCD, certain provisions on avoidance actions on account of the fraudulent conduct of the solvent party have not been disapplied by the FCAR. It has been seen in Chapter 7.2.2 that this has been interpreted so they still apply to close-out netting arrangements. Whilst it is understandable on morality grounds that the parties should not be allowed to act fraudulently when concluding their close-out netting arrangements, the English legislator has now created a situation whereby certain provisions have been disapplied, other provisions are deemed to continue to apply as there is involved the bad faith or fraudulent intent of the parties, whereas there could be yet other provisions which have not been specifically disapplied and do not fall under the type of avoidance actions based on fraud or bad faith. In this case the parties are left with the uncertainty whether these are covered by regulation 12(1) of the FCAR. In this grey area, the parties will have to resort to interpretation rules of common law to resolve the issue, one of these being that contracts should be interpreted to meet the reasonable expectations of the parties.

The French legislator, on the other hand, has laid down general derogations from civil execution action in article L.211-36-1, II of the Financial Code and from the entire book VI of the Commercial Code dealing with insolvency proceedings (including corresponding provisions under foreign law) in article L.211-40, and did not subject them to any conditionalities. This was also the situation prior to the implementation of the FCD. Two possible influences of the civil law system to which French law belongs can help explain this situation. The first is the civil law characteristic that the law is what the legislator states it is and there is no or little debate on morality issues. This may result in less balancing of public and private interests and may lead to different expectations than would subsist in common law jurisdictions. Indeed, it has been seen in Chapter 5.4.1 that for a considerable period of time French civil law permitted trade to continue after the commencement of insolvency proceedings as this was considered beneficial for the viability of the failing business. Even the set-off of claims was permitted if arising after insolvency whilst restrictions of connexity were (and still are) imposed to allow set-off of pre-insolvency debts. In this scenario, the French legislator chose not to impose any restrictions or conditionality relating to the time when the financial obligation has arisen as foreseen in Article 8(2) of the FCD. Second, a tendency of civil law systems is for laws to be drafted as general rules which are then interpreted to apply to different situations. It will therefore be up to the courts to apply any 'mandatory' restrictions which should be read into the general derogations protecting close-out netting provisions. In this case, it would be expected that the courts would declare invalid a close-out netting provision if this has been fraudulently entered into on account of the insolvency, but it would leave uncertain the extent to which the courts are free to annul a close-out netting provision on other grounds, such as on the basis of the moment of entering into the financial obligation if fraudulent intent cannot be proved.

8.4.4 The US Situation

Finally, it may or may not be a coincidence that at the time EU Member States were expected to implement the FCD (and in most cases this was expected to significantly widen the scope of recognition of close-out netting provisions), the US legislator enacted BAPCPA in 2005 which arguably brought about the most wide-ranging amendments to the existing safe harbours. The possible influence lies not so much in the importation into BAPCPA of the actual drafting of the FCD, since BAPCPA amends and retains the style of drafting of the existing safe harbours, but potentially the influence lies in the fact that considering the wide scope of application of the FCD and on the other hand the narrow scope of application of the original safe harbours, the US legislator may have felt the need to revamp the safe harbours in a number of ways already foreseen in Chapter 6.3. Just to highlight a major amendment of BAPCPA, the widening of the scope of the original safe harbours included the expansion of the definitions of the various contracts covered by the safe harbours similar to the style adopted for defining a swap agreement in relation to section 560 of the Bankruptcy Code. Thus, each defined contract (*e.g.* 'securities contract', 'commodities contract', 'forward contract', 'repurchase agreement', *etc.*) was similarly defined in style to include a list of known contracts, including any other similar agreements, a combination of agreements or an option to enter into such a contract, including a master agreement and any security or credit enhancement related thereto. BACPCA also expanded the type of parties that may benefit from the safe harbour in relation to each contract and created the notion of 'financial participant' who, provided certain thresholds are met, may qualify for protection under any of the safe harbours. In one aspect BAPCPA went beyond the FCD and introduced the concept of cross-product netting incorporated in section 561 of the Bankruptcy Code. The overall impression is that the US legislator, following the enactment of the FCD in 2002, did not wish to fall behind the movement of the EU-wide strengthening of close-out netting regimes.

8.5 The Effect of Resolution Measures

Different sources have shaped the close-out netting regimes of the three selected jurisdictions. Thus, whilst under English law, close-out netting initially developed under party autonomy as an external source of law and relied on the rules of insolvency set-off for its legitimacy until it became necessary for the English legislator to implement the provisions of the FCD, under both French and US laws the self-regulation by market associations is made evident, *inter alia*, by the reference in their national law provisions to the rules and terms of standard agreements adopted by these market associations.[73] Further significant changes occurred to these regimes in the aftermath of the financial crisis of 2007-2009 by the adoption of bank resolution regimes by national legislators.

The impetus of these resolution regimes is arguably based on recommendations made by international regulatory organisations which, although not having the force of law, have strongly influenced national legislators to adopt resolution regimes on the basis of moral suasion. It has been seen in Chapter 3 that organisations such as the BIS, FSB and IMF have issued reports or declarations between 2010 and 2011 recommending that close-out netting provisions, collateral arrangements and early termination clauses should not operate so as to frustrate the effectiveness of resolution measures required to be taken in relation to a failing financial institution for financial stability purposes. The main recommendation is that the exercise of the respective rights under these arrangements should be temporarily delayed. These recommendations also acknowledged the need to safeguard creditors' rights so that the right balance is achieved between the protection of financial stability and the rights of creditors under private arrangements.

These recommendations have not only influenced national legislators to amend their close-out netting regimes to provide for the supremacy of resolution laws, but also financial market associations which had originally influenced the development of close-out netting regimes had to amend their master agreements to take into account the overriding importance of these national resolution regimes. Thus, ISDA, which had been instrumental in lobbying for national close-out netting regimes in the early 1990s, was constrained to amend both its Model Netting Law[74] to restrict the exercise of close-out netting rights to allow for the effectiveness of national resolution measures and to issue Resolution Stay Protocols[75] which provide for the cross-border recognition of national resolution laws in order to conform with these national resolution regimes.

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73 This reflects the legal doctrine of the applicable legal systems whereby English law being a common law jurisdiction recognises party autonomy as an external source of law, whilst the French and US regimes being a civil and hybrid system respectively would rely on statutory recognition of party autonomy.

74 See ISDA 2018 Model Netting Act, section 4(j).

75 See the ISDA 2015 Universal Resolution Stay Protocol, the ISDA Resolution Stay Jurisdictional Modular Protocol & the ISDA 2018 U.S. Resolution Stay Protocol.

A major development in the EU in relation to bank resolution is the adoption of the BRRD, already discussed in Chapter 3, which seeks to harmonise the restrictions imposed on the exercise of close-out netting rights and establishes the necessary safeguards to protect those rights. Without doubt the BRRD had a significant influence on the role given to contractual freedom under the English and French netting regimes. However, it has also been seen in Chapter 7.3.2 that there are certain important differences in the implementation of the BRRD which indicate that the French legislator was more faithful than its English counterpart in such implementation. This difference could result in part from the fact that England had a bank resolution law since 2008 which was a temporary law enacted to resolve the failure of Northern Rock and which pre-dates the declarations and recommendations made by the BIS, FSB and IMF. This was replaced by the Banking Act 2009 and was later adapted to fulfil the BRRD requirements. As a result, certain modalities already applying under the former law were retained. On the contrary, the French legislator enacted the first resolution regime at the time the BRRD proposal was being discussed and the first law was in fact based on this proposal. There is a reversal of what occurred at the time the FCD was adopted when, there being no English close-out netting law in existence, the English legislator followed closely the wording of the FCD in its implementation, whilst the French legislator sought to adapt existing close-out netting legislation with the result that the terminology and style of drafting is different from that of the FCD. This goes to show that the English and French legislators were less restrained by their legal doctrine in cases where no law existed prior to the implementation of EU directives.

Taking into account the provisions of the BRRD which are deemed to represent best practice in the area of resolution measures, three types of restrictions may, generally speaking, affect the exercise of close-out netting rights. First, Article 68 of the BRRD imposes a ban on the exercise of early termination rights on the sole basis that a resolution measure has been adopted provided substantive obligations under the netting arrangement continue to be performed. Second, a temporary suspension is imposed under Article 71 on the exercise of termination rights and the performance of other obligations to enable the resolution authority to exercise resolution powers, having due regard to the effect this might have on the orderly functioning of the financial markets. These rights become immediately effective after the expiration of the suspension and even before if certain conditions concur. The third is more in the form of a safeguard and prohibits under Article 77 the partial transfer of obligations under a netting arrangement in order not to frustrate the possibility for the netting creditor to eventually be able to exercise its netting rights under the netting contract.

Considered from a general perspective, these restrictions and safeguards are found in all three selected jurisdictions so that there is indeed a global trend on the type of restrictions and general safeguards which has been arguably influenced by international regulatory bodies and the EU.

Still, national law influences were not totally eliminated, especially in cases where the national legislators had already in place national resolution measures. One noticeable difference between the three selected jurisdictions is that prior to the BRRD, the three regimes did not provide for safeguards to the netting creditors other than the general one that the partial transfer of obligations is prohibited. Following the adoption of the BRRD and the safeguards provided therein, the English and French legislators updated their laws to include these safeguards, whilst US law, which has not been influenced by the BRRD, now has less safeguards in place than the other two jurisdictions.

Distinctive approaches have been taken by the three selected jurisdictions in relation to the scope of application of the resolution measures. The English legislator retained its original approach of excluding the reorganisation and liquidation of a bank and certain investment firms, whether systemically important or not, from the scope of the Insolvency Act and regulating the resolution, administration and winding-up of these entities in the Banking Act. Arguably following the failure of Northern Rock, the English legislator deemed it necessary for financial stability purposes to regulate the failure of a bank through separate legislation and this did not change with the implementation of the BRRD. On the other hand, the BRRD has exerted a significant influence upon the French legislator which limits the application of the French resolution measures to banks and investment firms considered systemically important in terms of the BRRD. A different perspective has been adopted by the US legislator in the FDIA and OLA regimes. Both regimes regulate the recognition of close-out netting arrangements and the resolution of banks and systemically important non-bank financial institutions in similar terms, but whilst FDIA does so in case of every bank which is thus no longer subject to the provisions of the Bankruptcy Code, under OLA a determination has to be made whether a failing non-bank financial institution is deemed to be of systemic importance to be treated under the provisions of OLA instead of the Bankruptcy Code. It appears that whilst general statements of international bodies may have started the momentum for the adoption of resolution regimes, each legislator has sought to define, on the basis of the experience of national financial institutions' failures, what level of protection needs to be adopted to ensure the stability of the financial system. This is the case of the English and US legislators which have siphoned off banks and certain financial institutions from the general provisions of insolvency law, whilst the French legislator which originally adopted resolution law based on the proposal for the BRRD continued adapting this law to implement the final version of the BRRD into national law keeping the same scope of application.

A marked difference between the US regime on the one hand, and the English and French regimes on the other relates to the inclusion of safeguards to protect creditors' rights from the exercise of resolution measures. It has been noted in Chapter 7.3.2 that prior to the adoption of the BRRD, the general trend was that no safeguards were available in all three jurisdictions save for the prohibition of partial transfer of obligations related to a netting contract. Following the adoption of the BRRD, this remains the approach under US law which therefore continues to be influenced by the strict financial stability purpose that resolution measures are meant to protect, whilst, as was expected, both the English and French legislators have adapted their resolution regimes to implement the BRRD safeguards. Overall it has been noted in Chapter 7 that the US resolution regimes are less favourable to the netting creditor both on account of the fact that US law at times imposes bans, as opposed to temporary suspensions, from the exercise of early termination rights and it offers less safeguards to netting creditors. One may here detect a similar attitude in the approach taken by Congress in the extensions to the safe harbours brought by BAPCPA in 2005, where, arguably on account of the pressure exerted by the industry, few, if any, restrictions were imposed on the recognition of close-out netting provisions. Similarly (but in the opposite direction), following the declarations by international regulatory bodies on the effectiveness of resolution measures, restrictions imposed by Congress on close-out netting by the resolution regime were not balanced out sufficiently by safeguards to protect close-out netting rights when this is justified. Thus, the tendency of Congress to be market-driven is consistent in the whole process.

The balance sought to be achieved by the BRRD is the result of negotiations between the EU Member States which could involve also the protection of national interests. But once adopted, it is expected to be implemented in a harmonised manner across the EU. Considering the English and French regimes, whilst there is adequate harmonisation in the parts of the law implementing the restrictions and safeguards concerning early termination rights and the prohibition of partial transfers, in relation to the bail-in provision the English legislator opted to retain two national law features not conforming with the BRRD provisions, namely not to close out the agreement when exercising bail-in[76] and to calculate the net amount either in accordance with the netting agreement or in accordance with the special bail-in provision where the valuation is made by the Bank of England.[77] It is doubtful whether these features are aligned with the requirements of the BRRD. Article 49(2) of the BRRD provides that resolution authorities 'shall exercise the write-down and conversion powers in relation to a liability arising from a derivative only upon or after closing-out the derivatives' and Article 49(3) of the BRRD provides that where derivative transactions are subject to a netting agreement the valuation of the transactions is to be made 'on a net basis in accordance with the terms of the agreement'. Since these provisions are expressed in mandatory terms, it would appear that the

76 In relation to this aspect, it has been noted in Chapter 4.2 that the definition of 'netting arrangements' in both sections 48(1)(d) and 48P of the Banking Act does not contemplate the closing out of transactions but simply the conversion of a number of claims or obligations into a net claim or obligation.

77 See in this respect HM TREASURY 2017 SRR Code of Conduct, paras 8.28-8.32.

English legislator is not given a choice to implement differently. However, it may also be recalled that the FCD permits national legislators to impose restrictions on the valuation of collateral and transactions in its Article 4(6) so it could be argued that the BRRD, in this sense, may be read in the light of Article 4(6) of the FCD and permit any national law restrictions on valuation. The approach adopted by the English legislator may be best explained by the fact that having already in place a resolution regime prior to the implementation of the BRRD must have resulted in certain discrepancies arising under the former law which were not properly addressed upon implementation of the BRRD. Another trait which has not been changed by the English legislator is the application of the resolution regime under the Banking Act to all banks, and not solely systemically important banks as foreseen by Article 1(1) of the BRRD. These are therefore instances where matters which are deemed to be harmonised under EU law continue to apply differently in the Member States not because an option has been given, but because national law continues to determine certain aspects notwithstanding the clear provisions of the EU Directive.

Just as the development of close-out netting regimes was initially put in motion by the proliferation of the derivatives industry and the issuance of reports such as the Lamfalussy Report which highlighted the need to have legal certainty under national law for the enforcement of close-out netting provisions, in a similar manner the financial crisis and the accompanying declarations of international regulatory bodies triggered the adoption of national resolution laws where it became necessary for financial stability purposes to restrict party autonomy to allow national authorities to deal with failing financial institutions. This resulted not only in the enactment of national resolution measures which placed restrictions on the exercise of close-out netting rights, but also led international market associations such as ISDA to amend their market agreements to give recognition to national resolution measures.

Arguably, on account of the influence of the aforesaid international declarations, the restrictions imposed on the exercise of close-out netting rights are relatively similar in the three selected jurisdictions and may indicate a global standard of restrictions on the exercise of close-out netting rights, albeit with slight variations in the personal scope of application. The BRRD has introduced a number of safeguards which may not have been included in the national regimes so that left on their own EU national legislators presumably would not have included them, as is currently the situation in the US. US netting law is arguably still market-driven so that the tendency of Congress is to bow to the pressure of the market without taking into account, to a greater or lesser degree, the balancing of rights in doing so. On the other hand, there is a limited reversal of the approaches taken by the English and French legislators. Thus, whilst the English legislator adopted more faithfully the FCD provisions into the FCAR notwithstanding the mandatory insolvency set-off rules, it retained traits of the original resolution regime when it adopted the BRRD and may therefore have retained its own characteristics, evidenced mainly in the bail-in provision. On the other hand, whilst the French legislator adapted its existing netting law to transpose the FCD and in the process retained the style of drafting of its original netting law, it was prepared to transpose more faithfully the provisions of the BRRD possibly since no resolution law was in existence before the BRRD proposal was issued.

8.6 Final Conclusions

This research has sought to analyse how a relatively modern risk-mitigating concept such as close-out netting whose development was driven by the financial markets has been implemented in the English, French and US jurisdictions which hail from different or hybrid legal systems. The analysis considered the main research question whether the legal systems of England, France and the US influenced the recognition in these jurisdictions of the concept of insolvency close-out netting as developed by the market. Three main 'yardsticks' have been relied upon to gauge this process. First, the development of close-out netting has been compared to that of set-off which aims to achieve the same economic result and as a long-standing concept is expected to give a good indication of the philosophy and pro-creditor or pro-debtor tendencies of the legal system to which it pertains. This research has therefore analysed whether this philosophy and precepts of the applicable legal system have influenced the development of insolvency close-out netting or whether there has been a severance from such influence. Second, consideration has been given to whether mandatory provisions of insolvency law continue to restrict the full recognition given to close-out netting provisions and whether the legislator was pursuing a particular state insolvency goal when developing the close-out netting regime. Third, the more recent adoption of resolution regimes and the pursuit of financial stability objectives has resulted in relatively similar restrictions imposed on the exercise of close-out netting rights as already developed under the national regimes. In addition, consideration was also given to the influence of the EU's FCD and BRRD on the development of close-out netting in England and France which could also have constituted a deviation from the precepts of their legal systems.

The interplay between the influences of the legal system and the *lex mercatoria* is evident in varying degrees in all three selected regimes. It is possibly under English law that the development of close-out netting was mostly influenced by the applicable legal system, *i.e* by common law. At a time when various legislators were enacting their new close-out netting regimes in the early 1990s in order to bring the required legal certainty to the enforceability of close-out netting provisions, the English legislator continued to give recognition to close-out netting under the rules of insolvency set-off and any deviation from such rules and thus any contractual enhancement to such rules could be considered by the courts as a means of contracting out of insolvency law. In the light of this legal uncertainty and in view of the approach taken by the legislator to continue to rely on existing common law sources to give recognition to close-out netting provisions, the Financial Law Panel deemed it necessary to issue a Guidance Note in 1993 to reinforce this legal certainty. Although the implementation of the FCD into English law solved the uncertainties surrounding the enforceability of close-out netting provisions, it has not changed the legislator's approach that close-out netting already worked under English law. This is evident from the statements made in the FCAR consultation document cited in this chapter and from the fact that the legislator did not take the opportunity to provide for an *ad hoc* close-out netting regime but instead chose to insert provisions granting it recognition in a legal framework whose scope of application is primarily intended to regulate financial collateral arrangements. The assumption can therefore be made that, had it not been for the obligation to implement the FCD, the English legislator would have recognised close-out netting provisions only within the confines of applicable common law and provided insolvency set-off and insolvency rules were adhered to.

The French and US legislators have also relied on the concept of set-off to construe their close-out netting regimes, but in both cases the legislator resorted to the rules of the market to regulate the setting off of claims under close-out netting. As a result, rather than resort to their respective legal systems as the basis for formulating the type of recognition to be granted to insolvency close-out netting, the French and US legislators were ready to rely on market practice and industry rules to regulate the recognition of close-out netting even though their respective legal systems (especially the civil law system of France) are typically prescriptive and do not readily rely on market practices as a primary source of law. The recognition of these practices was subsequently enshrined in the law in order to avoid doubt as to their status under the law. In fact, the French and US legislators have been more willing to facilitate the industry and did not feel constrained by the rules of set-off or insolvency law in order to do so. It is to be noted that under both jurisdictions set-off is a voluntary act and this approach taken to close-out netting confirms the statements made by Dalhuisen quoted in Chapter 7.2.1 that it is more probable that legislators will allow contractual enhancements to set-off in jurisdictions where set-off is subject to invocation or notification. Both jurisdictions have amended their close-out netting laws mainly to extend the material scope of application to cover more markets but have done so in different ways. Whereas the French legislator has sought to unify the close-out netting regime in keeping with the codification trend of a civil law system and even kept it separate from the financial collateral regime when implementing the FCD so that it continues to serve its original purpose of an indemnification mechanism, the US legislator retained and amended the existing safe harbours and sought to cover any uncertainties by enacting FDICIA, thus creating an overlap in the regulation of close-out netting. Besides the influence of the market to increase the scope of application of these two close-out netting regimes, there is also the fact that as a civil and hybrid law jurisdiction respectively, party autonomy may not be safely relied upon as an external source of law and the legislator is required to grant statutory recognition for a close-out netting provision to be deemed valid.

Another issue analysed is whether the debate on morality justification typically associated with common law jurisdictions could have influenced the development of the national close-out netting regimes. Also in this case, English law has been mostly influenced by the common law perspective on fairness and morality, followed by US law. Morality debates have surrounded the privileges given to set-off under both English and US laws since the fairness and justification grounds on which they are based may have been taken more from the point of view of the parties involved in the bilateral relations rather than the wider body of creditors. But whilst English law developed a flexible concept of insolvency set-off which could be resorted to for the recognition of close-out netting provisions prior to the FCAR, the US legislator continued to subject the exercise of set-off to the insolvency principles and to court intervention. Whilst significant debate on the extent of the privileges given to netting creditors and its effect on the *pari passu* principle arose in both jurisdictions, it seems that morality issues only minimally influenced the development of their close-out netting regimes. Thus, the FCAR imposes a 'moral' condition related to the actual or constructive knowledge of the pending insolvency and it is implied that avoidance actions continue to apply if fraudulent intent can be proved. Although no explicit condition on actual or constructive knowledge is imposed under the US safe harbours, it is understood that avoidance provisions also continue to apply. It can be assumed that the importance of the workability of this concept for the market was a check on legislators not to unduly restrict its recognition.

It does not seem that morality issues affected the development of close-out netting in France and this is typical of a civil law jurisdiction. Both set-off and close-out netting were given a functional purpose which is fulfilled by their respective regimes. Set-off is a method of extinguishment of obligations and continues to be regulated as such upon insolvency so that the legislator did not feel the need to create a separate concept of insolvency set-off but imposed general conditions such as the connexity of claims to permit the setting off of claims upon insolvency. Close-out netting, on the other hand, was developed to fulfil the purpose of an indemnification mechanism for the financial markets. The fulfilment of this purpose may have encouraged the legislator to facilitate the market and enlarge the material scope of the close-out netting regime in order to capture more financial market agreements, even though the implementation of the FCD may have further enlarged the scope beyond this original purpose. That issues of fairness or morality do not seem to have been of special concern is also seen in the unconditional derogations granted for the protection of close-out netting provisions from insolvency law and third-party civil action so that it is up to the courts to interpret these derogations to exclude action taken with fraudulent intent.

Although it is generally stated that common law jurisdictions have a tendency to be more pro-creditor and this is evidenced in particular in the recognition given to pre-insolvency contractual entitlements in these jurisdictions, there seems to be a reversal of the pro-debtor and pro-creditor approaches when considering the three selected close-out netting regimes. The English regime is perhaps the most limited in material scope since it is restricted to close-out netting provisions forming part of a financial collateral arrangement and it is also the regime imposing most conditionality. The French and US regimes are more market-driven and thus focused on the expansion of the material scope to cover more sectors of the financial markets. This approach may be difficult to reconcile with the pro-debtor tendency of their respective insolvency regimes and may be explained by the intention, expressed or otherwise, of the state to remain competitive on the market and is an indication that when faced with this state goal, less influence is exerted by the legal system on the recognition of close-out netting. The approach taken under the French and US regimes appears to confirm the comments made by Dalhuisen and Goode cited in part 1 of this chapter that notwithstanding that the *lex mercatoria* may traditionally be considered less acceptable in civil (and hybrid) law jurisdictions, however modern legislators would be willing to adapt their laws to meet the needs of international commerce.

Finally, the adoption of resolution regimes for the protection of financial stability has brought about a standardisation of the restrictions imposed on the enforcement of close-out netting provisions which saw the influence of recommendations of international regulatory bodies take over from that of the private industry. In the aftermath of the financial crisis and at the time these international regulatory bodies issued their recommendations, it is clearly noticeable that the level of restrictions imposed in the three jurisdictions on the exercise of close-out netting rights was virtually identical. Following the implementation of the EU's BRRD, the same restrictions remained but more safeguards were introduced to protect the close-out netting mechanism, albeit with differences in implementation into the English and French regimes. In this case it has been seen that English law, having a pre-existing bank resolution regime, has continued to be influenced by pre-existing law in the implementation of the close-out netting provisions of the BRRD. French law, having no pre-existing bank resolution law, has implemented the BRRD more faithfully. US law continues to develop its own, albeit similar, resolution regime which has nowadays resulted in a more restrictive exercise of close-out netting rights than applicable under the English and French resolution regimes. However, the general similarity in the type of restrictions imposed on the exercise of close-out netting rights in a resolution situation can only indicate that the pursuit of the public interest of maintaining financial stability has significantly influenced this and serves to underline that the pursuit of a public interest requires an international response for its effectiveness.

All in all, in reply to the question whether the legal systems of England, France and the US have influenced the recognition of insolvency close-out netting, the reply is yes for all three jurisdictions, but with varying degrees. It has been seen that English common law has exerted the most influence on such recognition whilst the French regime continues to be the one most ready to develop according to market practices notwithstanding the precepts of civil law. Although it may be considered contrary to expectations that a civil law jurisdiction such as France is more accommodating to market practices than a common law jurisdiction such as England, one may here notice the same trend repeating itself in relation to the historical acceptance of set-off as a market practice which was readily accepted in France but met with resistance in England. US law, on the other hand, continues to take a more balanced approach in the recognition of close-out netting as expected of the hybrid nature of the US legal system and may be said to continue to closely follow the European approach which in the recognition of close-out netting seems to be more liberal than the US. Even here history repeats itself since also with the advent of set-off, the US judges were mostly influenced by English doctrine and judgments in the formulation of their set-off rules.

Final Statements

A number of short statements may be made in relation to the final conclusions reached in this research.

1. First, close-out netting is considered in this thesis as a stand-alone concept whose scope of application may extend beyond the confines of the financial markets.
2. Second, contractual enhancements of close-out netting based on set-off are more probable where set-off is subject to invocation or notification, as opposed to when it is mandatory or self-executory.
3. Third, notwithstanding the traditional distinction between common and civil law jurisdictions as being pro-creditor and pro-debtor respectively, this research shows that such method of assessing a country's legal system is too generic. In the research it is demonstrated that competitiveness considerations may have resulted in civil law jurisdictions such as France being more amenable to change their laws to adapt to market developments.
4. Fourth, the development of close-out netting in a common law jurisdiction such as England, and to a lesser extent the US, morality and fairness considerations appear to have influenced the debate and development of close-out netting, whilst in a civil law jurisdiction such as France the dominant consideration appears to be the fulfilment of a functional purpose.
5. Fifth, and finally, the international dimension applicable to bank resolution regimes based on the pursuit of public interests such as financial stability and the protection against systemic risk has brought about a level of uniformisation in the type of restrictions imposed on the exercise of close-out netting rights.

Summary

Introduction

This research considers the development of the concept of insolvency close-out netting under the laws of England (*i.e.* England and Wales), France and the US. Close-out netting developed as a financial market risk mitigation tool on the basis of the *lex mercatoria* permitting the calculation of risks on a net, rather than gross, basis. The close-out netting process, when it takes effect in accordance with its terms in insolvency, has provided financial market participants with a substantial measure of self-help in enforcing their claims against an insolvent counterparty.

The reference to the development of close-out netting provisions under the *lex mercatoria* as used in this research refers to the way in which the close-out netting developed under sources of soft law. Resort to close-out netting provisions initially proliferated through the use of standard master agreements developed by private market associations, both on a national and global scale, mainly in the derivatives and repurchase markets. The need for legal certainty in the enforceability of close-out netting provisions was underlined in declarations issued by international regulatory bodies with the result that national legislators worldwide started to enact law to grant recognition to close-out netting provisions. An important milestone in the process of national statutory recognition of close-out netting has been the adoption of the EU's Financial Collateral Directive which imposes upon EU Member States the general obligation to base their recognition of close-out netting provisions on the standard of 'in accordance with their terms'.

The choice of jurisdictions for this comparative study has been motivated by the fact that England, France and the US pertain to different global legal systems which is expected to bring out differences in the development of insolvency close-out netting as a consequence of their diverse historical and legal heritage. Thus, English law is fundamentally based on the common law tradition. French law operates a civil law system based on Roman law, initially codified through the Napoleonic Code. US law, though following the common law tradition brought to the North American colonies from England, has traces of the civil law tradition in its state legal systems and may, to some extent, be considered as an eclectic system comprising elements of the civil and common law systems.

The main question to be addressed in this research is the following:

How does close-out netting in insolvency function under current English, French and US laws, and, more specifically, how have the legal systems of these jurisdictions influenced the recognition of insolvency close-out netting provisions?

Thus, the topic of close-out netting in insolvency under present English, French and US laws is approached from a historic-theoretical perspective. The reply to this research question is based on preliminary replies provided to three sub-questions which are answered mainly under the national law and comparative law chapters, namely (i) whether the development of the concept of close-out netting in these jurisdictions has been influenced by the respective jurisdiction's set-off rules or whether close-out netting has developed as an autonomous concept, (ii) whether the recognition given to close-out netting 'in accordance with its terms' has been affected by the norms and rules of the jurisdictions' national insolvency laws and state insolvency goals (and, if so, in what manner), and (iii) whether, following the global financial crisis of 2008 – 2009, a convergence can be noted in the restrictions imposed on the recognition of close-out netting provisions under these jurisdictions' national resolution regimes (and, if so, in what manner).

Part I

This research is divided into three parts and eight chapters. Part I contains the first three chapters of this research and introduces the main concepts or fields of law on which this research is based, namely the concept of close-out netting, its relationship with set-off and insolvency laws and resolution regimes, and the milestones of the development of close-out netting under the *lex mercatoria*. These first three chapters provide a theoretical overview of the main conceptual elements used in this research and indicates how they interact with each other.

In more detail, Chapter 1 describes the forms of netting developed by the financial markets to serve as a risk mitigation device. Although netting techniques bear distinctive forms, the economic outcome is always the same, *i.e.* the reduction of multiple exposures into one net exposure. This chapter also describes the advantages and disadvantages of close-out netting which may have influenced the level of recognition granted by national legislators, in particular in relation to the application of set-off and insolvency laws. A major influence on the recognition given to close-out netting provisions regards the pursuit of financial stability goals and the establishment of bank resolution regimes which resulted in the introduction of a number of restrictions imposed on the enforcement of close-out netting provisions to permit the exercise of resolution measures in relation to systemically important financial institutions. This chapter also examines the constitutive elements of close-out netting to enable a comparison to be made with the analogous concept of set-off. It refers to the three-step process leading to the close-out netting concept, consisting of the termination of outstanding obligations, their valuation and the determination of a net balance. These diverse ways in which these steps can feature in a close-out netting provision is illustrated by an analysis of the close-out netting provisions of the 2002 ISDA Master Agreement and the 2011 Global Master Repurchase Agreement. Chapter 1 further provides a historical overview of the reception of set-off, itself initially developed by the commercial society, in the three selected jurisdictions. It has been seen that whilst the development of set-off under French law was strongly influenced by the Roman law notion of *compensatio,* in both the English and US jurisdictions the reception of set-off was inspired by considerations of natural justice and efficacy of dealing with separate claims in one action. The purpose of this historical overview is to determine in Chapter 8 whether the philosophical thinking of national legislators of the three selected jurisdictions in the acceptance of the set-off concept still underpins the statutory recognition of close-out netting.

Chapter 2 analyses the interaction between close-out netting provisions on the one hand, and insolvency and resolution laws on the other. Insolvency law is typically mandatory law, reflecting public policy so that the enforceability of close-out netting provisions requires a carve-out from certain insolvency law principles in order to be effective. Amongst these are the principles of the prohibition of termination of transactions and the individual pursuit of creditor claims (the 'stay'), the repudiation of unfavourable contracts ('cherry-picking') and avoidance provisions where transactions are set aside or avoided when concluded during a suspect period on the assumption that there is an unjustified preference to some creditors. The end result of these derogations is the non-enforceability of the *pari passu* principle to close-out netting provisions. The special position of credit institutions and investment firms under resolution regimes is also considered in this chapter where prudential regulation and resolution are driven by financial stability considerations. Resolution regimes have brought about a reconsideration of the extent of recognition granted to close-out netting provisions and the introduction of certain restrictions such as the imposition of a temporary stay on the exercise of private termination rights to allow for the orderly resolution of these entities.

Chapter 3 considers the sources which are deemed in this research to have established a *lex mercatoria* in relation to the development of close-out netting as a market tool. Two main sources have been identified, namely (i) the recommendations and declarations made by international regulatory bodies on the need for certainty of the legal soundness of close-out netting provisions for the stability of financial systems and (ii) the standard market documentation or agreements of private global market associations, in particular in the derivatives industry, which depend on the enforceability of their close-out netting provisions for the growth of their industry. Chapter 3 enumerates and explains these sources, amongst which are the reports of public international bodies such as the Lamfalussy Report of the

Committee on Interbank Netting Schemes of the BIS (1990), the Giovannini Report (2001), the World Bank Principles for Effective Creditor Rights and Insolvency Systems (2001) and the United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law (2004). Foremost among the sources concerning private association efforts to promote the global statutory recognition of close-out netting provisions is ISDA with its master agreements and its ISDA Model Netting Law. Prior to the financial crisis, both sources were advocating the protection of close-out netting provisions in accordance with their terms and were generally in agreement that insolvency law should not hinder the enforceability of close-out netting provisions. Following the financial crisis, the international regulatory bodies took the lead in issuing declarations on the need to curb the favourable treatment given to close-out netting provisions upon insolvency in relation to failing bank institutions to enable resolution authorities to effectively exercise bank resolution measures. EU law has been designated as a third source of the *lex mercatoria.* Two particular legal acts have been singled out as having influenced the substantive nature of close-out netting regulation, namely the Financial Collateral Directive and the Bank Recovery and Resolution Directive. Chapter 3 assesses the impact of these two Directives in the area of close-out netting which is foremost a primary (binding) source of law for EU Member States but which may have exerted influence beyond the EU for other countries who wish to remain competitive in the market and may thus be considered as a special *lex mercatoria*.

Part II

In Part II on the national close-out netting regimes, each of Chapters 4, 5 and 6 analyses the extent of recognition granted to insolvency close-out netting provisions under the laws of England, France and the US, respectively. These chapters provide for each of these jurisdictions (i) a brief overview of the national insolvency proceedings, bank resolution laws and the applicable laws which grant recognition to insolvency close-out netting, (ii) a comparative analysis of the constitutive elements of the concepts of close-out netting and insolvency set-off, (iii) an examination of the way in which close-out netting developed and how it was affected by the promulgation of bank resolution regimes and (iv) a consideration of the rationale and principles forming the basis of national insolvency law and the congruence of derogations granted in favour of close-out netting with any public policy or insolvency goal established by the State. In this Part II, sub-questions (i) to (iii) referred to above in relation to the main question are analysed from the point of view of the national law of the three selected jurisdictions and the following preliminary conclusions were drawn for each of these sub-questions in preparation for the comparative analysis carried out in Chapter 7:

In relation to English law, (i) the influence of insolvency set-off rules on the recognition granted to close-out netting depends on the scope of application of the close-out netting provision. Those provisions falling within the scope of application of the Financial Collateral Arrangement (No. 2) Regulations 2003 (FCAR) are given recognition 'in accordance with their terms' and are not affected by insolvency set-off rules. On the other hand, close-out netting provisions not falling within the scope of the FCAR may need to be tailored on the mandatory rules of insolvency set-off in order not to be impugned in court as an attempt by the parties to contract out of insolvency law. (ii) English insolvency law generally enforces pre-insolvency contractual entitlements and recognises specified groups of preferential interests so that the preference given to close-out netting is aligned with English insolvency law principles. However, the widened scope of the application of the close-out netting regimes to cover agreements between corporates has raised the debate by English authors on the proportionality of this preference *vis-à-vis* the *pari passu* principle. Such preferential treatment may be explained in the light of insolvency goals set by the State which favour the competitiveness of the market. (iii) The provisions of the English Banking Act 2009 have introduced restrictions on the contractual freedom of the parties insofar as concerns close-out netting arrangements to ensure the effective exercise of resolution measures, but this is done with due consideration given to the fact that the rights of netting creditors should not be unduly restricted and safeguards have been put in place.

In relation to French law, (i) whilst the reference to set-off in article L.211-36-1 of the Monetary and Financial Code (the Financial Code) appears to be central to the regulation of close-out netting, this has not restricted the pace for the contractual enhancement on which the close-out netting concept is based. Beyond the requirement of reciprocity, the type of contractual enhancements permitted by French law for the recognition of close-out netting provisions indicates that set-off rules have not, generally speaking, influenced the more recent development or the interpretation of close-out netting rules. (ii) It has been noted that the French legislator granted broad derogations from insolvency law and third-party action under articles L.211-40 and L.211-36-1, II respectively of the Financial Code. However, other laws not captured by these derogations such as the law on conservatory measures adopted by the *Autorité de contrôle prudential et de resolution* under article L.612-33 of the Financial Code continue to apply. Thus, whilst the French legislator was liberal in the derogations granted under two specific regimes (*i.e.* insolvency law and civil execution action), no consideration seems to have been given to other regimes which could affect the recognition granted to close-out netting. (iii) The reply to the third sub-question is that the enactment of resolution law has also brought some modifications in the enforcement of close-out netting provisions which are closely similar to those imposed under English law. This is not a surprise considering that both the French and English regimes had to adhere to the EU's Bank Recovery and Resolution Directive. A number of interests are balanced out and safeguards are introduced, but the close-out netting mechanism itself remains intact so that an amount of protection has been given even in the ambit of public policy regimes such as the resolution regime.

In relation to US law, (i) it is deemed that the right of close-out netting protected under the safe harbours has no ties or links to the concept or rules of ordinary set-off but has been created as a separate concept based on the notion of protection of contractual rights in relation to financial contracts, possibly to suit the requirements of the derivatives market industry. Thus, the exercise of contractual close-out netting rights under the safe harbours is exonerated from observance of these principles or restrictions which still apply in respect of ordinary set-off under the Bankruptcy Code, save when exercised in bad faith. (ii) The safe harbours are an exception to the traditional rationale of US bankruptcy law which is aimed towards the discharge of the debtor and the preservation of the going-concern value of the enterprise. It has been found difficult to reconcile the protection given to close-out netting under the safe harbours with the pursuit of a particular goal or public policy followed by Congress which, except in relation to the application of resolution regimes, has chosen to give virtually full protection to close-out netting from the application of insolvency law principles. (iii) The financial crisis in the US heralded new considerations of systemic risk and led to the adoption of two resolution regimes, first the Federal Deposit Insurance Act (FDIA) for insured banks and subsequently the regime under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the OLA regime) for systemically important non-bank financial institutions. A primary goal of these resolution regimes is to promote the stability of the financial system. With the exception of the bail-in regime, the restrictions imposed by these regimes are reminiscent of those found under the English and French regimes.

Part III

In Part III conclusive replies are provided in Chapter 7 to the three sub-questions based on the preliminary conclusions reached in the national law chapters. These replies are then used in Chapter 8 to reply to the main research question.

In more detail, Chapter 7 undertakes a comparative analysis of all the aspects considered in Chapters 4 to 6 in order to establish trends and approaches taken by legislators in formulating their close-out netting regimes. A preliminary issue analysed is whether the concept of close-out netting is a uniform concept under the three regimes in a way that permits comparing it under the laws of the three selected jurisdictions. First, a comparative assessment is made whether and how the three-step process, comprising the rights of (i) termination, (ii) valuation and (iii) netting, which make up the close-out netting mechanism have been incorporated in the laws of the selected regimes. Second, the personal and material scope of application of national close-out netting regimes is analysed on a comparative basis in order to establish whether it can be said that at its core the close-out netting mechanism is restricted to the financial markets.

Having established that close-out netting has indeed developed as a stand-alone concept which can be the subject of comparative analysis and that all three jurisdictions widened its material or personal scope of application beyond the confines of the financial markets, Chapter 7 continues with a comparative analysis of the preliminary conclusions to the three sub-questions reached in the national law chapters. In relation to the first sub-question, the analysis focused on whether close-out netting evolved as a contractual enhancement of set-off (or not) and whether the rules governing set-off in any way still apply or shape the application of close-out netting. Under this part it has been found that the influence of set-off rules on the development of close-out netting is mostly present under English law which continued to influence the recognition of close-out netting provisions until the enactment of the FCAR. Although close-out netting under French law was built on the existing concepts of termination and set-off, the numerous occasions in which the French legislator has amended and finetuned the close-out netting regime indicates that from an early stage close-out netting developed as a separate stand-alone concept providing compensation against financial loss which was not influenced by set-off requirements. The link between ordinary set-off and close-out netting is mostly severed under US law. Indeed, the protection of contractual freedom of close-out netting under the safe harbours was recognised from the start and was based on protection from any stay, avoidance or court and administrative orders issued under the Bankruptcy Code.

In relation to the second sub-question, the comparative analysis considers whether the recognition given to close-out netting provisions is meant to serve declared or implied State insolvency goals. This is achieved in the first part by analysing whether a strategic decision was taken by the legislator or, where applicable, by the courts to link the special treatment given to close-out netting under insolvency law to the attainment of a public policy. In relation to English law, it has been seen that on account of its congruence with pre-insolvency contractual entitlements and its compatibility with a number of English law axioms, the recognition of close-out netting under the FCAR does not seem to have been based on any particular State insolvency goal other than the general goal of the preservation of pre-insolvency contractual rights. French law is considered the most liberal in relation to the influence of insolvency law principles given that there is a full and unconditional exemption for close-out netting from insolvency law. An assumption has been made in Chapter 7 that following the harmonisation of various aspects of the European single market, the opportunity was taken by the French legislator to focus on the competitiveness of the French market. Although the US safe harbours were originally based on the goal of protecting against systemic risk, the wide scope of application of the safe harbours was difficult to justify on these grounds. This led to debates on the path dependence theory in terms of which each new expansion of the safe harbours was used to justify further expansions. An assumption has been made that this trend may have been influenced by the lobbying pressure of the market.

In relation to the third sub-question, the comparative analysis focuses on the effect of resolution regimes on close-out netting in the pursuit of the goal of financial stability. A significant level of convergence has been noted in the resolution regimes of the three selected jurisdictions insofar as concerns the type of restrictions imposed on the exercise of close-out netting rights. On account of the implementation of the EU's Bank Recovery and Resolution Directive, more similarities have resulted in the English and French regimes. However, since the English regime predates the BRRD more restrictions have been imposed by English law when compared to French law which opted for the most favourable options to the netting creditor. US law has arguably adopted a more pronounced restrictive approach than the other two jurisdictions where more powers have been given to the resolution authorities to protect the exercise of resolution measures with less corresponding safeguards to creditors.

The comparative analysis of Chapter 7 serves to delineate the characteristics of the national close-out netting regimes of the three selected jurisdictions which may not have been possible if each were considered on its own. This analysis is used in Chapter 8 to draw conclusions on the influence of the legal systems of the three selected jurisdictions on the recognition granted to close-out netting provisions in reply to the main research question. The interplay between the influences of the legal system and the *lex mercatoria* is evident in varying degrees in all three selected regimes. It has been seen that had it not been for the obligation to implement the EU's Financial Collateral Directive, the English legislator would have recognised close-out netting only within the confines of applicable common law and provided insolvency set-off and insolvency rules were adhered to. The French and US legislators have also relied on the concept of set-off to construe their close-out netting regimes, but in both cases the legislator resorted to the rules of the market (rather than the rules of ordinary set-off) to regulate the setting off of claims under close-out netting. Since their respective legal systems are typically prescriptive and do not readily rely on market practices as a primary source of law, in both these jurisdictions the recognition of these practices was subsequently enshrined in the law in order to avoid doubt as to their status at law. An argument is also made that it may not be a coincidence that the US legislator enacted the most wide-ranging amendments to the safe harbours shortly after the Financial Collateral Directive was enacted which may give the overall impression that the US legislator did not wish to fall behind the movement of the EU-wide strengthening of close-out netting regimes.

Another issue analysed is whether the debate on morality justification typically associated with common law jurisdictions could have influenced the development of the national close-out netting regimes. Morality debates have surrounded the privileges given to set-off under both English and

US laws and whilst it seems that significant debate on the extent of the privileges given to netting creditors and its effect on the *pari passu* principles arose in both jurisdictions, morality issues only minimally influenced the development of their close-out netting regimes. It does not seem that morality issues affected at all the development of close-out netting in France and this is deemed typical of a civil law jurisdiction. Both set-off and close-out netting were given a functional purpose (*i.e.* as a method of payment and as a market indemnification mechanism, respectively) which is fulfilled by their respective regimes. That issues of fairness and morality do not seem to have been of special concern under French law is also seen in the unconditional derogations granted from insolvency law and third-party civil action.

Although it is generally stated that common law jurisdictions have a tendency to be more pro-creditor and this is evidenced in particular in the recognition given to pre-insolvency contractual entitlement in these jurisdictions, there seems to be a reversal of the pro-debtor and pro-creditor approaches when considering the three selected close-out netting regimes. The English regime is perhaps the most limited in material scope since it is restricted to close-out netting provisions forming part of a financial collateral arrangement and it is also the regime imposing most conditionality. The French and US regimes are more market-driven and thus focused on the expansion of the material scope to cover more sectors of the financial markets. This approach may be difficult to reconcile with the pro-debtor tendency of their respective insolvency regimes and may be explained by the intention, expressed or otherwise, of the State to remain competitive on the market. This indicates that when faced with this particular state goal, less influence is exerted by the legal system on the recognition of close-out netting.

The adoption of resolution regimes for the protection of financial stability has brought a standardisation of the restrictions imposed on the enforcement of close-out netting provisions which saw the influence of recommendations of international regulatory bodies take over from that of the private industry. In the aftermath of the financial crisis and at the time these international regulatory bodies issued their recommendations, it is clearly noticeable that the level of restrictions imposed in the three jurisdictions on the exercise of close-out netting rights are virtually identical and this in pursuit of the public interest of maintaining financial stability which requires an international response for its effectiveness. Whilst the English and French regimes have been influenced by the implementation of the EU's Bank Recovery and Resolution Directive, English law, having a pre-existing bank resolution regime, continued to be influenced by pre-existing law in the implementation of the close-out netting provisions of the BRRD. French law, having no pre-existing bank resolution law, implemented the BRRD more faithfully. US law continues to develop its own, albeit similar, resolution regime which has nowadays resulted in a relatively more restricted exercise of close-out netting rights.

Conclusion

Thus, in reply to the main research question whether the legal system of England, France and the US have influenced the recognition of insolvency close-out netting, the reply is yes for all three jurisdictions but with varying degrees. It has been seen that English common law has exerted the most influence on such recognition whilst the French regime continues to be the one most ready to develop according to market practices notwithstanding the precepts of civil law. The US legal system, being a hybrid system, continues to exert a more balanced influence.

Samenvatting (Summary in Dutch)

Close-out Netting in Insolventie: Een rechtsvergelijkende studie naar Engels, Frans en Amerikaans recht in mondiaal perspectief

Introductie

Dit onderzoek betreft de vervroegde beëindiging van een financiële raamovereenkomst ('*close-out netting*') naar het recht van Engeland (d.w.z. Engeland en Wales), Frankrijk en de Verenigde Staten (VS). Met close-out netting wordt bedoeld de beëindiging vanwege een verzuim onder de overeenkomst – al dan niet door insolventie –, waarbij alle transacties die onder de raamovereenkomst tussen partijen tot stand zijn gekomen, in één keer volgens een vooraf afgesproken systeem worden afgewikkeld. Close-out netting ontwikkelde zich als instrument ter beperking van financiële marktrisico's op basis van *lex mercatoria*, waardoor het mogelijk wordt gemaakt om risico's op netto-basis, in plaats van bruto-basis, te berekenen. Het proces van close-out netting biedt, wanneer het overeenkomstig de overeengekomen voorwaarden tijdens insolventie kan worden uitgevoerd, participanten op de financiële markten een aanzienlijke vrijheid hun vorderingen jegens een insolvente tegenpartij af te dwingen.

Een verwijzing naar de ontwikkelingen van de bepalingen inzake close-out netting onder de *lex mercatoria* zoals gebruikt in dit onderzoek, verwijst naar de manier waarop close-out netting is ontwikkeld door bronnen van zogenoemde niet-bindende regelgeving (*soft law*). Aanvankelijk nam het gebruik van bepalingen inzake vervoegde verrekening toe door gebruik daarvan in de raamovereenkomsten die waren ontwikkeld door zowel nationale als internationale brancheorganisaties en die met name zijn gericht op de derivaten- en retrocessie (*repo*)-markten. De noodzaak van rechtszekerheid bij het afdwingen van bepalingen inzake close-out netting werd onderstreept in verklaringen van internationale regelgevende instanties, met als resultaat dat nationale wetgevers regels uitvaardigden die bepalingen inzake close-out netting sanctioneerden. Een belangrijke mijlpaal in het proces van erkenning van close-out netting in nationale wetgeving, was de inwerkingtreding van de EU Richtlijn betreffende financiëlezekerheidsovereenkomsten, die de algemene verplichting oplegt aan EU-lidstaten om close-out nettingbepalingen te erkennen 'in overeenstemming met hun voorwaarden'.

De keuze voor de jurisdicties in dit rechtsvergelijkend onderzoek is ingegeven door het feit dat Engeland, Frankrijk en de VS tot verschillende rechtsstelsels behoren, wat heeft geleid tot verschillen in de ontwikkeling van close-out netting als gevolg van hun diverse historische en juridische geschiedenis. Zo is Engels recht in de kern gebaseerd op de *common law* traditie. Het Frans recht hanteert een civielrechtelijk systeem dat is gebaseerd op Romeins recht en aanvankelijk was gecodificeerd in de Napoleontische Code. Het recht van de VS volgt de *common law* traditie die vanuit Engeland naar de Noord-Amerikaanse koloniën is gebracht, maar bevat ook sporen van de civielrechtelijke traditie en kan, tot op zekere hoogte, worden beschouwd als een eclectisch systeem dat elementen bevat van zowel het civielrechtelijke als het *common law* systeem.

De hoofdvraag die in dit onderzoek aan de orde komt is de volgende:

Hoe functioneert close-out netting tijdens insolventie naar huidig Engels, Frans en VS recht, en in het bijzonder, hoe hebben de rechtsstelsels van deze jurisdicties de erkenning van bepalingen inzake close-out netting tijdens insolventie beïnvloed?

Het onderwerp van close-out netting naar huidig Engels en Frans recht en het recht van de VS wordt dus benaderd vanuit een historisch-theoretisch perspectief. Het antwoord op de onderzoeksvraag is gebaseerd op de beantwoording van drie deelvragen, die met name worden beantwoord in de hoofdstukken inzake nationale wetgeving en rechtsvergelijking, namelijk: (i) of de ontwikkeling van het concept close-out netting in deze jurisdicties is beïnvloed door de verrekeningsbepalingen van de desbetreffende jurisdicties of dat deze autonoom tot stand is gekomen; (ii) of de erkenning die aan close-out netting is gegeven 'in overeenstemming met de voorwaarden' is beïnvloed door de normen en regels uit nationale insolventiewetten en insolventiedoelstellingen van de desbetreffende jurisdicties (en zo ja, op welke manier); en (iii) of na de wereldwijde financiële crisis van 2008-2009 convergentie kan worden gesignaleerd in de beperkingen die de nationale resolutieregimes opleggen aan de erkenning van bepalingen inzake close-out netting (en zo ja, op welke manier).

Deel I

Dit onderzoek is opgedeeld in drie delen en acht hoofdstukken. Deel I bevat de eerste drie hoofdstukken en introduceert de belangrijkste concepten of rechtsfiguren waarop dit onderzoek is gebaseerd, namelijk: het concept close-out netting, de relatie daarvan tot verrekeningsbepalingen in insolventiewetten en resolutieregimes, en de mijlpalen in de ontwikkeling van close-out netting onder *lex mercatoria*. Deze eerste drie hoofdstukken geven een overzicht van de belangrijkste conceptuele elementen die in dit onderzoek worden gebruikt en geven aan hoe deze zich met elkaar verhouden.

Meer in het bijzonder beschrijft Hoofdstuk 1 de vormen van verrekening die door de financiële markten zijn ontwikkeld om te dienen als instrument teneinde risico's te mitigeren. Hoewel er verschillende vormen van verrekening zijn, is het economische resultaat altijd hetzelfde, namelijk: het reduceren van meerdere uitstaande blootstellingen (*exposures*) tot één netto-blootstelling (*net exposure*). Dit hoofdstuk beschrijft ook de voor- en nadelen van close-out netting die mogelijk van invloed zouden kunnen zijn geweest op de mate van erkenning verleend door nationale wetgevers, met name waar het de toepassing van verrekeningsbepalingen in insolventiewetten betreft. Een grote invloed op de erkenning van de bepalingen inzake close-out netting is het nastreven van de doelstelling van financiële stabiliteit en de totstandbrenging van afwikkelingsregelingen voor banken, hetgeen resulteerde in een aantal beperkingen op de uitoefening van bepalingen inzake close-out netting bij het uitvoeren van afwikkelingsmaatregelen gerelateerd aan systeemrelevante financiële instellingen. In dit hoofdstuk worden ook de constitutieve elementen van close-out netting onderzocht om een vergelijking te kunnen maken met het analoge concept van de commune civielrechtelijke verrekening. Verwezen wordt naar het driestappenproces dat leidt tot an close-out netting, te weten: de beëindiging van uitstaande verplichtingen, hun waardering en het vaststellen van een netto-saldo. De diverse manieren waarop deze stappen een rol kunnen spelen bij bepalingen inzake close-out netting, worden geïllustreerd met een analyse van de bepalingen inzake close-out netting van de ISDA Master Agreement van 2002 en de Global Master Repurchase Agreement van 2011. Verder geeft Hoofdstuk 1 een historisch overzicht van de ontwikkeling van verrekening, die in eerste instantie tot stand is gekomen in het commerciële verkeer in de drie geselecteerde jurisdicties. Hoewel de ontwikkeling van verrekening naar Frans recht sterk werd beïnvloed door de Romeinse figuur *compensatio*, is aangetoond dat in zowel de Engelse jurisdictie als in het recht van de VS de opkomst van verrekening werd geïnspireerd door overwegingen van natuurrecht en de efficiëntie van het behandelen van afzonderlijke vorderingen in één actie. Het doel van dit historische overzicht is om in Hoofdstuk 8 te bepalen of de rechtstheoretische grondslagen van de nationale wetgevers uit de drie geselecteerde jurisdicties achter de acceptatie van het verrekeningsconcept, nog steeds ten grondslag liggen aan de wettelijke erkenning van vroegtijdige verrekening.

Hoofdstuk 2 analyseert de interactie tussen bepalingen inzake close-out netting enerzijds en insolventie- en afwikkelingsregelgeving anderzijds. Insolventierecht is doorgaans dwingend recht dat zekere sociale beleidsdoelen weerspiegelt. Het afdwingen van bepalingen inzake close-out netting vereist uitzondering op bepaalde beginselen van insolventierecht om effectief te zijn. Daartoe behoren onder meer het fixatiebeginsel, de opschorting van het verhaal van schuldeisersvorderingen (de *'stay'*), de afwijzing van ongunstige contracten (*'cherry-picking'*) en paulianabepalingen, waarbij transacties ter zijde worden gesteld als deze zijn afgesloten tijdens een verdachte periode en de indruk wordt gewekt dat sprake is van een ongerechtvaardigde voorkeursbehandeling van bepaalde schuldeisers. Het resultaat van deze uitzonderingen is dat het *pari passu*-beginsel ten opzichte van de bepalingen inzake close-out netting niet onverkort wordt toegepast. In dit hoofdstuk komt tevens de bijzondere positie van kredietinstellingen en beleggingsondernemingen met betrekking tot afwikkelingsregelingen aan de orde, waarbij prudentiële regulering en afwikkeling (resolutie) worden bepaald door overwegingen van financiële stabiliteit. Resolutieregimes hebben geleid tot een heroverweging van de mate van erkenning die is verleend aan bepalingen inzake close-out netting en de invoering van bepaalde beperkingen, zoals het opleggen van een tijdelijk schorsing van de uitoefening van individuele rechten van beëindiging van overeenkomsten teneinde een ordelijke afwikkeling van deze entiteiten mogelijk te maken.

Hoofdstuk 3 behandelt de bronnen waarvan in dit onderzoek wordt aangenomen dat ze een *lex mercatoria* hebben bewerkstelligd, in relatie tot de ontwikkeling van close-out netting als marktinstrument. Twee belangrijke bronnen zijn geïdentificeerd, namelijk: (i) de aanbevelingen en verklaringen van internationale regelgevende instanties over de noodzaak van rechtszekerheid ten aanzien van bepalingen inzake close-out netting voor de stabiliteit van financiële markten; en (ii) de standaardmarktdocumentatie of overeenkomsten van internationale handelsorganisaties, met name uit de derivatenmarkt, die afhankelijk zijn van de afdwingbaarheid van bepalingen inzake close-out netting voor de groei van hun sector. In hoofdstuk 3 worden deze bronnen, waaronder de rapporten van internationale instanties, zoals het Lamfalussy-rapport van de Commissie voor Interbank Netting Schemes van de BIS (1990), het Giovannini-rapport (2001), de World Bank Principles for Effective Creditor Rights and Insolvency Systems (2001) en de United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law (2004), toegelicht. Met betrekking tot de inspanningen van handelsorganisaties om de wereldwijde wettelijke erkenning van bepalingen inzake close-out netting te bevorderen zijn meerdere bronnen te vinden, waarvan ISDA met zijn raamovereenkomsten en zijn ISDA Model Netting Law de belangrijkste is. Vóór de financiële crisis pleitten beide bronnen voor de bescherming van bepalingen inzake close-out netting in overeenstemming met hun voorwaarden, en waren zij het over het algemeen erover eens dat toepasselijke insolventiewetgeving niet in de weg mag staan aan de afdwingbaarheid van bepalingen inzake close-out netting. Na de financiële crisis hebben internationale regelgevende instanties het voortouw genomen door verklaringen af te geven over de noodzaak tot beteugeling van bepalingen inzake close-out netting tijdens insolventie voor falende banken, opdat de afwikkelingsautoriteiten effectief afwikkelingsmaatregelen kunnen nemen. Als derde bron van *lex mercatoria* wordt EU-wetgeving in ogenschouw genomen. Twee specifieke regelingen zijn aangemerkt als van invloed op de inhoudelijke aard van de regelgeving inzake close-out netting, namelijk: de Richtlijn betreffende financiëlezekerheidsovereenkomsten en de Richtlijn herstel en afwikkeling van banken en beleggingsondernemingen. Hoofdstuk 3 beoordeelt de impact van deze twee richtlijnen op het gebied van close-out netting, welke in de eerste plaats een primaire (bindende) rechtsbron is voor EU-lidstaten, maar hetgeen mogelijk ook invloed uitoefent op andere landen buiten de EU die willen concurreren op de markt en dus kan worden beschouwd als een speciale *lex mercatoria*.

Deel II

In Deel II over de nationale regelingen inzake close-out netting wordt in elk van de hoofdstukken 4, 5 en 6 de mate van erkenning geanalyseerd die wordt toegekend aan de bepalingen inzake close-out netting tijdens insolventie naar het recht van, respectievelijk, Engeland, Frankrijk en de VS. Deze hoofdstukken voorzien voor elk van deze jurisdicties in: (i) een beknopt overzicht van de nationale insolventieprocedures, resolutieregimes en de toepasselijke wettelijke bepalingen die erkenning verlenen aan vroegtijdige verrekening tijdens insolventie; (ii) een vergelijkende analyse van de constitutieve elementen van vroegtijdige verrekening en commune verrekening (*set-off)* tijdens insolventie; (iii) een onderzoek naar de manier waarop close-out netting zich ontwikkelde en hoe deze werd beïnvloed door de invoering van afwikkelingsregimes voor banken; en (iv) een beschouwing van de ratio en de beginselen die de basis vormen van de nationale insolventiewetgeving en de toegestane afwijkingen met betrekking tot close-out netting van een door de staat vastgesteld beleid of insolventiedoelstelling. In dit deel II, worden de subvragen (i) tot en met (iii), waarnaar hierboven wordt verwezen, met de hoofdvraag in het achterhoofd geanalyseerd vanuit het oogpunt van het nationale recht van de drie geselecteerde jurisdicties en worden de volgende voorlopige conclusies getrokken voor elk van de deze deelvragen – ter voorbereiding op de rechtsvergelijking die in Hoofdstuk 7 aan de orde komt:

Wat betreft het Engels recht, (i) hangt de invloed van de regels over verrekening in insolventie op de erkenning van vroegtijdige verrekening af van het toepassingsgebied van de bepaling inzake close-out netting. De bepalingen die binnen het toepassingsgebied van de Financial Collateral Arrangement (No. 2) Regulations 2003 (FCAR) vallen, krijgen erkenning 'in overeenstemming met hun voorwaarden' en worden niet beïnvloed door de regels voor commune verrekening tijdens insolventie. Anderzijds kan het nodig zijn dat bepalingen inzake close-out netting die niet onder het toepassingsgebied van de FCAR vallen, worden aangepast aan de dwingende regels van commune verrekening tijdens insolventie om te voorkomen dat partijen voor de rechter moeten verschijnen vanwege een poging om onder het insolventierecht uit te contracteren. (ii) Naar Engels insolventierecht zijn contractuele rechten in beginsel afdwingbaar vóór insolventie en worden specifieke groepen preferentiële belangen erkend, zodat de voorkeursbehandeling die wordt gegeven aan close-out netting in overeenstemming is met de beginselen van het Engelse insolventierecht. De verbreding van de toepassing van de close-out netting-regimes tot overeenkomsten tussen niet-financiële ondernemingen heeft echter de discussie over de proportionaliteit van deze voorkeursbehandeling ten opzichte van het *pari passu*-beginsel onder Engelse auteurs doen oplaaien. Een dergelijke voorkeursbehandeling zou kunnen worden verklaard in het licht van de door de staat vastgestelde insolventiedoelstellingen gericht op marktwerking. (iii) De bepalingen van de Banking Act 2009 hebben beperkingen ingevoerd op de contractsvrijheid van partijen, voor zover het gaat om overeenkomsten aangaande close-out netting, om de effectieve uitvoering van afwikkelingsmaatregelen te waarborgen, maar hierbij wordt terdege rekening gehouden met het feit dat de rechten om te kunnen verrekenen niet onnodig mogen worden beperkt en er waarborgen moeten zijn getroffen.

Met betrekking tot het Frans recht: (i) hoewel de verwijzing naar verrekening uit artikel L.211-36-1 van het Monetair en Financieel Wetboek (het Financieel Wetboek) centraal lijkt te staan in de regulering van close-out netting, heeft deze vorm van regulering de contractsvrijheid op het gebeid van close-out netting niet beperkt. Naast het vereiste van wederkerigheid geeft de vorm van contractsvrijheid, die door de Franse wet is toegestaan inzake close-out netting, aan dat de regels inzake verrekening in het algemeen geen invloed hebben gehad op recente ontwikkeling of de interpretatie van bepalingen inzake close-out netting. (ii) Er is vastgesteld dat de Franse wetgever op grond van respectievelijk de artikelen L.211-40 en L.211-36-1, II van het Financieel Wetboek ruimte heeft gelaten voor afwijking van de insolventiewetgeving en beperkingen van vorderingen van derden. Andere wetten die niet onder deze afwijkingen vallen, zoals de wet inzake bewarende maatregelen die door de *Autorité de contrôle prudential et de resolution* is aangenomen op grond van artikel L.612-33 van het Financieel Wetboek, blijven echter van toepassing. Dus hoewel de Franse wetgever liberaal was in de afwijkingen die werden toegestaan op grond van twee specifieke regelingen (namelijk insolventierecht en civielrechtelijke rechtsvordering (‘*civil execution action*’)), lijkt geen rekening te zijn gehouden met andere regelingen die de erkenning van close-out netting zouden kunnen beïnvloeden. (iii) Het antwoord op de derde deelvraag is dat de totstandkoming van de resolutiewet ook enkele wijzigingen heeft aangebracht in de handhaving van de bepalingen inzake close-out netting. Deze wijzigingen lijken sterk op bepalingen die door de Engelse wetgeving worden voorgeschreven. Dit is geen verrassing, aangezien zowel het Franse als het Engelse regime uitwerkingen zijn van de Richtlijn herstel en afwikkeling van banken en beleggingsondernemingen. Een aantal belangen wordt afgewogen en een aantal waarborgen wordt ingevoerd, maar het mechanisme van close-out netting zelf blijft intact waardoor een zekere mate van bescherming is geboden, zelfs in het kader van regimes zoals het afwikkelingsregime.

Met betrekking tot de Amerikaanse wetgeving: (i) wordt aangenomen dat het recht op close-out netting dat valt binnen een beschermingsbepaling (‘*safe harbour*’), geen banden of rechtsrelatie heeft met het concept of de regels van commune verrekening, maar als een afzonderlijk concept is gecreëerd dat op basis van de veronderstelde bescherming van contractuele rechten met betrekking tot financiële contracten dient om te kunnen voldoen aan de eisen van de derivatenmarkt. De contractuele afdwingbaarheid van rechten inzake close-out netting die vallen onder de beschermingsbepalingen is dus vrijgesteld van de toepassing van de beginselen of beperkingen die gelden voor commune verrekening onder de Bankruptcy Code, behalve wanneer deze rechten te kwader trouw worden uitgeoefend. (ii) De beschermingsbepalingen vormen een uitzondering op de traditionele grondgedachte achter de Amerikaanse faillissementswetgeving die uitgaat van kwijting van de schuldenaar en het behoud van de bedrijfswaarde van de onderneming. Het blijkt moeilijk om de bescherming die wordt geboden aan close-out netting onder de beschermingsbepalingen te verenigen met een bepaald doel of beleid dat wordt gevolgd door het Congres. Overigens heeft het Congres ervoor gekozen om vrijwel volledige bescherming te bieden aan close-out netting tegen de toepassing van de beginselen van het insolventierecht, behalve waar het de toepassing van afwikkelingsregimes betreft. (iii) De financiële crisis heeft nieuwe bepalingen in het leven geroepen met betrekking tot twee afwikkelingsregelingen. De eerste is de Federal Deposit Insurance Act (FDIA) voor banken en de tweede is het regime onder Titel II van de Dodd-Frank Wall Street Reform and Consumer Protection Act (het OLA regime) voor systeemrelevante niet-bancaire financiële instellingen. Een primair doel van deze afwikkelingsregimes is het bevorderen van de stabiliteit van het financiële stelsel. Met uitzondering van het bail-in-regime, doen de beperkingen die deze regimes opleggen denken aan die van het Engelse en Franse resolutieregime.

Deel III

In deel III worden de drie subvragen in Hoofdstuk 7 beantwoord aan de hand van de voorlopige conclusies die zijn getrokken in de hoofdstukken betreffende nationaal recht. De beantwoording van de deelvragen wordt vervolgens in Hoofdstuk 8 gebruikt om de hoofdvraag te beantwoorden.

Hoofdstuk 7 werkt een vergelijkende analyse uit van alle aspecten die in de hoofdstukken 4 tot en met 6 aan de orde komen. Het doel is om vast te stellen welke trends en benaderingen de wetgevers hebben gevolgd bij het formuleren van hun regelingen voor close-out netting. Een van de eerste kwesties die wordt geanalyseerd is of het concept van close-out netting onder de drie regimes een uniforme rechtsfiguur vormt waardoor het mogelijk is om deze te vergelijken naar het recht van de drie geselecteerde jurisdicties. Ten eerste wordt een rechtsvergelijkende beoordeling gemaakt van de vraag of en op welke wijze het driestappenproces, bestaande uit de rechten van (i) beëindiging, (ii) waardering en (iii) verrekening, die deel uitmaakt van het mechanisme voor close-out netting, in de wetgeving van de geselecteerde jurisdicties is opgenomen. Ten tweede wordt het persoonlijke en materiële toepassingsgebied van deze nationale regelingen voor close-out netting op vergelijkende basis geanalyseerd om vast te stellen of kan worden gezegd dat het mechanisme voor close-out netting in wezen beperkt is tot de financiële markten.

Nadat is vastgesteld dat close-out netting zich inderdaad heeft ontwikkeld tot een aparte rechtsfiguur die onderwerp kan zijn van vergelijking en dat alle drie de jurisdicties hun materiële of persoonlijke toepassingsgebied hebben verruimd buiten de grenzen van de financiële markten, gaat hoofdstuk 7 verder met een vergelijkende analyse van de voorlopige conclusies van de drie deelvragen die in de hoofdstukken over nationaal recht zijn uitgewerkt en beantwoord. Met betrekking tot de eerste deelvraag was de analyse gericht op de vraag of close-out netting evolueerde als een contractuele versterking van commune verrekening (of niet) en of de regels voor commune verrekening op enigerlei wijze nog steeds van toepassing zijn of de toepassing van close-out netting vormgeven. In dit onderdeel is geconstateerd dat vooral naar Engels recht de invloed van de commune verrekeningsregels op de ontwikkeling van close-out netting sterk is, terwijl de erkenning van bepalingen inzake close-out netting beïnvloed bleef worden tot aan de inwerkingtreding van de FCAR. Hoewel close-out netting naar Frans recht was gebaseerd op de bestaande concepten van beëindiging en gewone verrekening, duiden de talrijke keren dat de Franse wetgever het regime voor close-out netting heeft gewijzigd en verfijnd erop dat close-out netting vanaf een vroeg stadium is ontstaan als een afzonderlijk, opzichzelfstaand concept dat compensatie biedt voor financiële verliezen en dat niet is beïnvloed door eisen van commune verrekening. Het verband tussen commune verrekening en close-out netting wordt onder de Amerikaanse wetgeving grotendeels verbroken. De bescherming van de contractsvrijheid met betrekking tot close-out netting onder de beschermingsbepalingen werd immers vanaf het begin erkend en was gebaseerd op bescherming tegen elke opschorting, paulianaregels of gerechtelijke en administratieve bevelen uitgevaardigd krachtens de Bankruptcy Code.

Met betrekking tot de tweede deelvraag wordt in de rechtsvergelijkende analyse nagegaan of de erkenning die wordt gegeven aan bepalingen inzake close-out netting is bedoeld om de uitgesproken of geïmpliceerde insolventiedoelstellingen van de desbetreffende nationale staat te dienen. Dit wordt in het eerste deel bereikt door te analyseren of een strategische beslissing is genomen door de wetgever of, indien van toepassing, door de rechtspraak om de bijzondere behandeling van close-out netting onder het insolventierecht te gebruiken om een beleidsdoelstelling te realiseren. Met betrekking tot het Engels recht valt op dat, vanwege de overeenstemming met de contractuele rechten vóór insolventie en de verenigbaarheid met een aantal axioma's van Engels recht, de erkenning van close-out netting onder de FCAR niet lijkt te zijn gebaseerd op een specifiek insolventiedoelstelling van de staat, met uitzondering van het algemene doel om contractuele rechten aangegaan vóór insolventie te behouden. Frans recht wordt als meest liberaal beschouwd met betrekking tot de invloed van de beginselen van het insolventierecht, omdat er een volledige en onvoorwaardelijke uitzondering van het insolventierecht geldt voor close-out netting. In hoofdstuk 7 is aangenomen dat, na de harmonisatie van verschillende aspecten van de Europese interne markt, door de Franse wetgever de gelegenheid werd aangegrepen om het mededingingsvermogen van de Franse markt te versterken. Hoewel de Amerikaanse beschermingsbepalingen oorspronkelijk waren gebaseerd op het doel om bescherming te bieden tegen systeemrisico's, was het brede toepassingsgebied van de beschermingsbepalingen op deze gronden moeilijk te rechtvaardigen. Dit leidde tot discussies over de zogenoemde *path dependence theory* waarbij elke nieuwe uitbreiding van de beschermingsbepalingen werd gebruikt om verdere uitbreidingen te rechtvaardigen. Aangenomen is dat deze trend mogelijk zou zijn beïnvloed door de lobbydruk vanuit de markt.

Met betrekking tot de derde deelvraag richt de vergelijkende analyse zich op het effect van afwikkelingsregimes op close-out netting bij het nastreven van de doelstelling van financiële stabiliteit. Er is een aanzienlijke mate van convergentie vastgesteld in de afwikkelingsregelingen van de drie geselecteerde rechtsgebieden wat betreft het soort beperkingen dat wordt opgelegd aan de uitoefening van rechten inzake close-out netting. De implementatie van de Richtlijn herstel en afwikkeling van banken en beleggingsondernemingen van de EU heeft geleid tot grote overeenkomsten tussen de Engelse en Franse regimes. Aangezien het Engelse regime dateert van vóór de BRRD, zijn er echter door het Engelse recht meer beperkingen aan close-out netting opgelegd in vergelijking met het Franse recht, dat koos voor de meest gunstige opties voor de verrekenende schuldeiser. Amerikaans recht heeft aantoonbaar een meer restrictieve benadering gevolgd dan de andere twee rechtsgebieden, waar afwikkelingsautoriteiten meer bevoegdheden hebben om de uitoefening van afwikkelingsmaatregelen te beschermen en waar schuldeisers tegelijkertijd minder waarborgen hebben.

De vergelijkende analyse uit hoofdstuk 7 onderzoekt de nationale regelingen van de drie geselecteerde jurisdicties inzake close-out netting, die niet mogelijk zou hebben kunnen zijn als elke jurisdictie afzonderlijk zou worden onderzocht. Deze analyse wordt in Hoofdstuk 8 gebruikt om conclusies te trekken over de invloed van de rechtsstelsels van de drie geselecteerde jurisdicties op de verleende erkenning van bepalingen inzake close-out netting, als antwoord op de in dit onderzoek gestelde hoofdvraag. De wisselwerking tussen beïnvloedingen van het rechtssysteem en de *lex mercatoria* is in verschillende mate zichtbaar bij alle drie geselecteerde regimes. Er is vastgesteld dat zonder de verplichte tenuitvoerlegging van de Richtlijn betreffende financiëlezekerheidsovereenkomsten van de EU, de Engelse wetgever close-out netting alleen zou hebben erkend binnen de grenzen van het toepasselijke *common law* en op voorwaarde dat de commune verrekeningsregels tijdens insolventie en de bepalingen van het insolventierecht worden nageleefd. De Franse en Amerikaanse wetgevers hebben eveneens vertrouwd op het concept van de commune verrekening om hun regelingen voor close-out netting te interpreteren, maar beide wetgevers namen hun toevlucht tot regels die gelden op de markt (in plaats van de regels die gelden voor commune verrekening) om de vroegtijdige verrekening van vorderingen te reguleren. Aangezien de rechtstelsels van beide rechtsgebieden doorgaans prescriptief zijn en niet snel vertrouwen op marktpraktijken als primaire rechtsbron, werd de erkenning van deze praktijken vervolgens voor beide rechtstelsels in de wet verankerd om twijfel over hun rechtspositie te voorkomen. Ook wordt aangevoerd dat het geen toeval mag zijn dat de Amerikaanse wetgever de meest uitgebreide wijzigingen in de beschermingsbepalingen heeft aangenomen kort nadat de Richtlijn betreffende financiëlezekerheidsovereenkomsten van de EU was aangenomen, hetgeen de algemene indruk kan wekken dat de Amerikaanse wetgever niet wilde achterblijven bij de ontwikkeling van de EU-brede versterking van regelingen voor close-out netting.

Een andere kwestie die wordt geanalyseerd is of de discussie over de morele rechtvaardiging, die doorgaans plaatsvindt binnen *common law*-jurisdicties, de ontwikkeling van de nationale regelingen voor close-out netting zou kunnen hebben beïnvloed. Morele discussies draaien om de voorrechten die onder zowel de Engelse als de Amerikaanse wetgeving aan verrekening worden gegeven en hoewel het lijkt alsof er in beide rechtsgebieden een aanzienlijke discussie bestond over de omvang van de voorrechten die werden verleend aan schuldeisersverrekening en het effect daarvan op de *pari passu*-beginselen, beïnvloedde de morele kwesties de ontwikkeling van hun regeling voor close-out netting minimaal. De conclusie is daaruit getrokken dat het erop lijkt dat de ontwikkeling van close-out netting in Frankrijk helemaal niet is beïnvloed door morele kwesties, hetgeen als typisch wordt beschouwd voor een civielrechtelijke jurisdictie. Zowel commune verrekening als close-out netting kreeg een functioneel doel (d.w.z. respectievelijk als betaalmiddel en als marktvergoedingsmechanisme) waaraan wordt voldaan door hun respectieve regimes. Dat kwesties van rechtvaardigheid en moraliteit volgens Frans recht niet van bijzonder belang lijken te zijn, blijkt tevens uit de onvoorwaardelijke afwijkingen van het insolventierecht en de civielrechtelijke vorderingen van derden die zijn toegestaan.

Hoewel over het algemeen wordt aangenomen dat *common law*-jurisdicties geneigd zijn om crediteur-vriendelijk te zijn, hetgeen met name blijkt uit de erkenning die in deze jurisdicties wordt verleend aan contractuele pre-insolventierechten, lijkt in dit geval sprake te zijn van een omkering van debiteur- en crediteur-vriendelijke benaderingen. De Engelse regeling heeft wellicht de meest beperkte materiële reikwijdte, aangezien deze beperkt is tot bepalingen inzake close-out netting die deel uitmaken van een financiëlezekerheidsovereenkomst, en het de regeling is die de meeste voorwaarden oplegt. De Franse en Amerikaanse regimes zijn meer marktgericht en daardoor gericht op het uitbreiden van de materiële reikwijdte naar meer sec--toren binnen de financiële markten. Deze benadering kan moeilijk worden verenigd met de debiteur-vriendelijke neiging van hun desbetreffende insolventieregelingen en kan worden verklaard door de, al dan niet uitdrukkelijke, intentie van deze staten om te kunnen blijven concurreren op de financiële markten. Dit geeft aan dat waar men wordt geconfronteerd met dit specifieke beleidsdoel, door het desbetreffende rechtssysteem minder beperkingen worden opgelegd aan de erkenning van close-out netting.

De aangenomen afwikkelingsregelingen ter bescherming van de financiële stabiliteit hebben geleid tot een standaardisering van opgelegde beperkingen aan de handhaving van bepalingen inzake close-out netting, waarbij de invloed van aanbevelingen van internationale regelgevende instanties het overnam van die van de private sector. Tijdens de nasleep van de financiële crisis en op het moment dat deze internationale regelgevende instanties hun aanbevelingen deden, is het duidelijk merkbaar geworden dat de niveaus van beperkingen die in de drie jurisdicties zijn opgelegd aan de uitoefening van close-out netting vrijwel identiek zijn en dat dit, in het kader van het algemeen belang om de financiële stabiliteit te handhaven, een internationale respons vereist om doeltreffend te zijn. Hoewel de Engelse en Franse regimes zijn beïnvloed door de implementatie van de Richtlijn herstel en afwikkeling van banken en beleggingsondernemingen van de EU, werd de Engelse wet, vanwege een reeds bestaand afwikkelingsregime voor banken, beïnvloed door bestaande wetgeving bij de implementatie van de bepalingen inzake close-out netting. De Franse wet, die een reeds bestaand afwikkelingsregime voor banken niet kende, implementeerde de BRRD meer getrouw. De Amerikaanse wetgeving blijft haar eigen, zij het vergelijkbare, afwikkelingsregime ontwikkelen, hetgeen tegenwoordig heeft geresulteerd in een relatief beperktere uitoefening van close-out netting.

Conclusie

In antwoord op de onderzoeksvraag of het rechtssysteem van Engeland, Frankrijk en de VS de erkenning van vroegtijdige verrekening tijdens insolventie heeft beïnvloed, is het antwoord bevestigend voor alle drie de jurisdicties, zij het in verschillende mate. Aangetoond is dat de Engelse *common law* de meeste invloed heeft uitgeoefend op een dergelijke erkenning, terwijl het Franse regime het meest bereid is om op basis van marktpraktijken door te ontwikkelen ondanks de voorschriften van het civiele recht. Het Amerikaanse rechtssysteem blijft dankzij het hybride karakter een meer evenwichtige invloed uitoefenen.

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Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/30/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of

the Council, [2014] OJ L 173/190, as amended by Directive (EU) 2019/879, [2019] OJ L 150/296 (EU Bank Recovery and Resolution Directive, 'BRRD')
(Intro A.4, 3.2.4, 3.3, 3.3.1.1, 3.3.2, 3.3.2.1, 3.4, 4.2, 4.3, 4.4.2, 7.3.2, 7.4, 8.1, 8.5, 8.6), Recital (95) (3.3.2), Art. 1(1) (8.5), Art. 1(1)(a)-(e) (3.3.2), Art. 2(1)(98) (1.1.1, 3.3.2.1, 4.3), Art. 9a (3.3.1.1), Art. 31(2) (3.3.2), Art. 32(1) (3.3.2), Art. 32(4) (3.3.2), Art. 33a (3.3.2.1), Art. 34(1)(g) (7.3.2), Art. 42(4) (3.3.2), Art. 37(3) (3.3.2), Art. 43 (3.3.2, 3.3.2.1), Art. 44 (3.3.2.1), Art. 44(3) (3.3.2.1), Art. 49 (3.2.4, 3.3.2.1), Art. 49(2) (8.5), Art. 49(3) (8.5), Art. 68 (3.2.4, 3.3.2.1, 8.5), Art. 68(3) (3.3.2.1), Art. 69 (3.2.4, 3.3.2.1), Art. 70 (3.3.2.1), Art. 71 (Intro, 3.2.4, 3.3.2.1, 8.5), Art. 71(3) (3.3.2.1), Art. 71(4) (3.3.2.1), Art. 71(5)(a) (3.3.2.1), Art. 71(5)(b) (3.3.2.1), Art. 71(6) (3.3.2.1), Art. 76 (Intro, 3.3.2.1), Art. 76(1) (3.3.2.1), Art. 77 (Intro, 3.3.2.1, 8.5), Art. 78 (3.3.2.1), Art. 80 (3.3.2.1), Art. 117 (3.2.4), Art. 118 (3.3.1.1)

Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC, (BRRD II) [2019] OJ L 150/296
(Intro, 3.2.4), Art. 1(29) (3.3.2.1)

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(4.3)

Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings [2015] OJ L 141 (EU Recast Insolvency Regulation)
(3.2.4), Art. 7 (3.2.4), Art. 9 (3.2.4)

Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), [2008] OJ L 177/6
(3.2.4), Art. 9 (3.3.2.1, 5.3), Art. 17 (3.2.4)

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, [2012] OJ L 201/1
Art. 2(5) (4.3)

Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, [2013] OJ L 176/1
Art. 205 (1.1), Art. 206 (1.1)

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(Intro, Intro A.4, 3.2.4, 3.3.2), Art. 5 (3.2.4), Art. 29 (3.2.4)

Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms, (SRM II) [2019] OJ L 150/226
(Intro, 3.2.4)

Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, [1989] OJ L386/1
(3.2.4)

Treaty of the European Community, [1997] OJ/C 340/173 – Consolidated version
Art. 95 (3.3.1)

Treaty on the Functioning of the European Union ('TFEU'), [2012] C 326/47
Art. 26 (3.3.1), Art. 114 (3.3.1, 3.3.2), Art. 114(1) (3.3.1)

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Code Civil (Civil Code)
(Intro A.4, 5.2.2, 7.2.2, 8.2), art. 1244-1 (5.3), art. 1244-1 – 1244-3 (5.3), art. 1244-2 (5.3), art. 1289 (5.2.1), art. 1289 – 1299 (5.2.1, 8.2), art. 1290 (5.2.1, 5.2.2, 7.1.1, 8.2), art. 1295 (5.2), art. 1343-2 (5.1, 5.3), art. 1347 (5.2, 5.2.1, 5.2.2, 7.2.1, 8.2), art. 1347-1 (5.2.1), art. 1347-6 (5.2.1), art. 1347 – 1348 (8.2), art. 1348 (5.2.1, 5.2.2, 7.2.1), art. 1348-1 (5.2.1, 5.2.2), art. 1348-2 (5.2.1, 5.2.2)

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Book VI (5.1, 7.2.2), art. 611-7 (5.3), art. L.620-1 (5.1), art. L.621-107 (7.2.2), art. L.621-108 (7.2.2), art. L.622-7 (5.1, 5.2.1, 5.2.2, 5.3, 7.2.1), art. L.622-7, I (5.1, 8.2, 8.3.2.1), art. L.622-9 (5.4), art. L.622-13 (5.1, 5.4, 7.2.2), art. L.622-17 (5.1, 5.2.1, 5.4, 7.2.1), art. L.622-21 (5.1, 5.4), art. L.622-24 (5.2.1, 8.2), art. L.631-1 (5.1), art. L.632-1 (7.2.2), art. L.632-2 (7.2.2, 8.2), art. L.640-1 (5.1), art. L.640-13 (5.1, 5.4), art. L.641-11-1 (5.4), art. L.643-7-1 (5.1)

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(Intro A.4, 5.3), Art. L.211-1 (5.1, 5.2.2, 7.1.2, 8.3.2.2), art. L.211-1, I (5.1), art. L211-1, III (5.1), art. L.211-36 (5.1, 5.2, 5.2.2, 5.3, 5.4, 7.2.1, 8.3.2.1, 8.3.2.2), art. L.211-36, I (5.2.2), art. L211-36, II (5.1, 5.2.2, 7.1.2), art. L.211-36-1 (5.1, 5.2, 5.2.2, 5.3, 5.4, 5.5, 7.1.1, 7.1.2, 7.2.2, 7.3.2, 8.3.2.2, 8.3.2.3, 8.3.2.4, 8.3.3.1), art. L.211-36-1, I (5.2, 5.2.2, 7.1.1, 7.2.1), art. L.211-36-1, II (5.1, 5.2, 5.2.2, 5.3, 7.1.1, 8.3.2.3, 8.3.3.3, 8.4.3), art. L.211-36-2 (5.1), art. L.211-38 (7.1.1, 7.3.2, 8.3.2.2), art. L.211-38, I & IV (5.2, 7.1.1), art. L.211-40 (5.1, 5.2, 5.2.2, 5.3, 5.4, 5.5, 7.2.1, 7.2.2, 8.3.2.1, 8.3.2.3, 8.3.2.4, 8.4.3), art. L.312-4 (5.3), art. L.330-1 (5.1), art. L.431-7 (5.1, 5.2, 5.3, 7.1.2, 7.2.2, 8.3.2, 8.3.2.1, 8.3.2.2, 8.3.3.3, 8.4.1, 8.4.2), art. L.431-7-2(8.4.2), art. L.432-8 (5.3), art. L.432-16 (5.3), art. L.513-2(c)-(n) (5.1), art. L.531-2 (5.1), art. L.612-33 (5.3, 8.3.2.3), art. L.613-31-16 (5.3), art. L.613-31-16, IV (5.3), art. L.613-31-11 (5.1), art. L.613-34 (5.1, 5.3), art. L.613-34-1-12º (5.3), art. L.613-34-1-17º (5.2), art. L.613-34-1-19º (5.2), art. L.613-34-2 (5.3), art. L.613-47 (5.3, 7.3.2), art. L.613-48 (5.1), art. L.613-49, II (5.1), art. L.613-50 (5.1), art. L.613-50-3 (7.3.2), art. L.613-50-4 (7.3.2), art. L.613-52 (5.3), art. L.613-52 (5.3, 7.3.2), art. L.613-50-4 (5.3), art. L.613-55-1 (5.3), art. L.613-55-6 (5.3, 7.3.2), art. L.613-55, I – 1º (5.3), art. L.613-56-2 (5.3), art. L.613-56-2, I (5.3), art. L.613-56-3 (7.3.2), art. L.613-56-3, II (5.3), art. L.613-56-3, III (5.3, 7.3.2), art. L.613-56-5 (5.3, 7.3.2), art. L.613-56-5, I (5.3), art. L.613-56-5, IV (5.3), art. L.613-56-6 (5.3), art. L.613-57 (7.3.2), art. L.613-57-1 (5.3, 7.3.2), art. D.211-1 (5.1)

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art. L.262 (5.3), art. L.263 (5.3)

Roman Law

Codex Just. 4.31.14
(1.2.1, 1.4)

J. Institutiones 4.6.30
(1.2.1, 8.2)

The United States of America

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. No. 109-008 (2005) ('BAPCPA')
(6.3, 8.3.3.2, 8.3.3.3, 8.4.4, 8.5), § 101(25) (6.3), § 101(38A) (6.3), § 101(53B) (6.3), § 741(7) (6.3), § 761(4) (6.3), § 907 (6.3)

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12 C.F.R. §§47.4-5 (6.1), 12 C.F.R. § 231 (Regulation EE) (6.2, 7.1.2, 8.3.3.2), 12 C.F.R. §§ 252.83-84 (6.1), 12 C.F.R. §§ 382.3-4 (6.1)

Federal Deposit Insurance Act of 1950, Pub.L. 81-797, 64 Stat. 873, incorporated in 12 U.S.C. ('FDIA')
(Intro A.4, 6.1, 6.2, 6.3, 6.4, 6.4.1, 6.5, 7.3.2, 7.4, 8.3.3.3)

Federal Deposit Insurance Corporation Improvement Act of 1991, Pub.L. 102-242, 105 Stat. 2236, incorporated in 12 U.S.C. ('FDICIA')
(Intro A.4, 6.1, 6.3, 6.4.1, 7.1.2, 7.3.1, 7.4, 8.3.3.1, 8.3.3.2, 8.3.3.4, 8.5, 8.6), §§ 401 – 407 (6.3), § 402 (6.2, 7.1.1, 7.1.2, 7.3.1), § 402(14) (6.2, 6.2.2, 8.3.3.2), § 402(14)(A)(i) (6.2), § 403 (6.2, 6.2.2, 6.3, 6.4.2, 6.5, 7.1.1, 7.2.1, 7.2.2, 8.3.3.2, 8.3.3.3), § 403(a) (8.3.3.3), § 403(1) (8.3.3.1), § 403(14)(A) (8.3.3.2), § 404 (6.2), § 407 (7.2.20

Financial Netting Improvements Act of 2006, Pub.L. No. 109-390, 120 Stat. 2692
(6.3)

Securities Investor Protection Act of 1970, Pub.L. No. 91-598, 84 Stat. 1636
§5(b)(2) (6.3)

Title 11 of the United States Code (11 U.S.C.) ('Bankruptcy Code', 'the Code')
(Intro A.4, 6.1, 6.2, 6.3, 6.2.2, 6.4, 6.5, 7.1.2, 7.2.2, 7.4, 8.3.3.3, 8.3.3.4), Chapter 7 (6.1, 6.4.2, 7.3.2), Chapter 11 (6.1, 6.4, 6.4.1, 6.4.2, 7.3.1), § 101 (7.1.2), § 101(2) (6.2.1), § 101(5) (6.2.1), § 101(19) (6.3), § 101(22A) (7.1.2, 8.3.3.2), § 101(36) (6.3), § 101(38A) (6.2, 6.5), § 101(49)(A) (6.3), § 101(53C) (8.3.3.2), § 109 (6.1), § 109(b)(2) (6.1), § 301 (6.1), § 303 (6.1), § 354(e)(1)(A) (8.3.3.4), § 362 (6.2), § 362 (6.3), § 362(a) (6.1, 8.3.3.4), § 362(a)(3) (6.4.1), § 362(a)(5) (6.4.1), § 362(a)(7) (6.2.2), § 362(a)(b)(1)(g) (6.4.1), § 362(b)(6) (6.1, 6.3, 7.1.2), § 362(b)(7) (6.2.1, 6.3), § 362(b)(6), (7), (17) & (27) (6.1), § 362(d)(1) (6.2.1), § 363 (6.2, 6.2.1), § 365(e) (6.1), § 365(e)(1) (6.2, 6.2.2), § 502 (6.2.1), § 506(a) (6.2.1, 8.2), § 507 (6.1, 6.4.10, § 546 (6.3), § 546(e) (6.3), § 546(e)-(g) & (j) (6.1, 6.2.2), § 546(f) (6.3), § 546(g) (7.2.2), § 546(j) (6.3), § 547 (6.1), § 548 (6.2.1, 8.2), § 548(d)(2) (6.1), § 553 (6.2.1, 6.2.2, 6.5, 7.2.1, 8.2), § 553(a) (6.2, 6.2.1, 6.2.2, 8.2), § 553(a)(2) (6.2.1), § 553(a)(3) (6.2.1), § 553(a)(2)(3) (8.2), § 553(b) (6.2.1, 8.2), § 553(b)(1) (6.1), § 555 (6.1, 6.2, 6.3, 7.1.2), §§ 555 – 556 (6.1), § 556 (6.1, 6.2, 6.3, 7.1.2), § 559 (6.1, 6.2, 6.3, 7.1.2), §§ 559-562 (6.1), § 560 (6.1, 6.2, 6.2.2, 6.3, 6.4, 6.4.2, 6.5, 7.1.1, 7.1.2, 7.2.1, 7.2.2, 7.3.1, 7.4, 8.3.3, 8.3.3.2, 8.3.3.3, 8.3.3.4, 8.4.4), § 561 (6.1, 6.2, 6.2.2, 6.3, 6.4.2, 6.5, 7.1.2, 7.3.1, 8.4.4), § 561(a) (6.2), § 561(b)(2) (7.2.2), § 561(c) (6.3), §§ 701 – 784 (6.1), § 704 (8.3.3.4), § 726 (6.1), § 741 (6.1), § 1101 (6.1), §§ 1101 – 1174 (6.1), § 1129(a)(9) (6.4.1)

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Conventions

UNIDROIT Convention on Substantive Rules for Intermediated Securities 2009 ('Geneva Securities Convention')
(3.2.3), Art. 33 (3.2.3)

Curriculum Vitae

Bernadette Muscat née Gatt (Mosta, Malta, 1970) spent most of her legal career in the financial and banking industry, specializing in European Union law. She obtained her diploma as notary public from the University of Malta in 1991 and continued to pursue studies at the same University leading to the degree of Doctor of Laws (LL.D.) which she obtained in 1993. In 1994 she pursued and obtained a master's degree (LL.M.) in European Law at the College of Europe in Bruges and in the same year was admitted to the Maltese Bar. In 2013 she started her research as an external Ph.D. candidate at Leiden Law School at Leiden University under the supervision of Prof Matthias Haentjens and Prof Bob Wessels. Bernadette commenced her career in 1994 at the European Union Directorate of the Ministry of Foreign Affairs and in 1996 moved to the financial industry, initially in the private banking sector. She has formerly headed the Legal Departments of the Central Bank of Malta and of the Malta Financial Services Authority and has worked as senior legal counsel at the Legal Services of the European Central Bank. She currently heads the Legal and Compliance Department of the Malta Development Bank. Bernadette has also held a number of advisory and academic positions and has been appointed to sit as Board member of public sector regulatory entities.

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This comparative study has as its central theme insolvency close-out netting provisions, a core aspect of financial netting agreements. It takes as a point of departure the fact that close-out netting developed as a market tool under the *lex mercatoria*, as defined in this study, which should be given recognition "in accordance with its terms". This study compares the development of three national close-out netting regimes, namely English law being a common law jurisdiction, France as a civil law jurisdiction and US as a hybrid (common/civil law) jurisdiction. This choice of jurisdictions is intended to bring out contrasts in the philosophy and precepts of their diverse legal systems. The study takes a holistic view of the effect of various aspects of the recognition of close-out netting, primarily by comparing close-out netting to the analogous concept of set-off, by considering its interaction with mandatory insolvency law and the fulfilment of state insolvency goals, and, lastly, by gauging the impact of national resolution regimes on the exercise of close-out netting rights resulting from the pursuit of cross-border public interest objectives such as financial stability and systemic risk. The result serves to demystify stereotypes of creditor-friendliness jurisdictions typically associated with common law jurisdictions and to reveal the adaptability of modern legislators in civil law countries to remain competitive in the market.

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